Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	
Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements	**WC Docket No. 02-112**
2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules	**CC Docket No. 00-175**

Declaration

of

LEE L. SELWYN

on behalf of

AT&T Corp.

June 30, 2003

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DECLARATION OF LEE L. SELWYN

INTRODUCTION

Qualifications and Assignment

Lee L. Selwyn, of lawful age, declares and says as follows:

1. My name is Lee L. Selwyn; I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Suite 400, Boston, Massachusetts 02108. ETI is a research and consulting firm specializing in telecommunications and public utility regulation and public policy. My Statement of Qualifications is annexed hereto as Attachment 1 and is made a part hereof. I have been asked by AT&T to review the *Further Notice of Proposed Rulemaking* ("FNPRM" or

"Notice") issued by the Commission in the above-captioned proceeding, to analyze the issues and questions raised therein, and to provide the Commission with specific recommendations thereon.

2. I have participated in proceedings before the Federal Communications Commission ("FCC" or "Commission") dating back to 1967 and have appeared as an expert witness in hundreds of state proceedings before more than forty state public utility commissions. I have participated in numerous regulatory proceedings involving public utility affiliate relationships and inter-affiliate transactions and transfers. These have included merger proceedings before the California PUC involving Pacific Telesis Group and SBC, and Bell Atlantic and GTE, before the Illinois Commerce Commission involving SBC and Ameritech, before the Connecticut Department of Public Utility Control involving SBC and SNET, and before the Maine PUC involving NYNEX and Bell Atlantic. I also participated in written comments filed with the FCC regarding both the SBC/Ameritech and Bell Atlantic/GTE merger applications. I have participated in a number of Section 271 proceedings, including those in Pennsylvania, New Jersey, California, Minnesota, Delaware and Virginia. I have also submitted testimony before several state commissions addressing proposals for structural separation of ILEC wholesale and retail operations. I participated in proceedings before the California PUC involving Pacific Bell's reorganization of its Information Services (primarily voice mail) business into a separate subsidiary, and the spin-off of Pacific Telesis Group's wireless services business into a separate company. I have participated in a number of matters involving the treatment of transfers of yellow pages publishing from the ILEC to a separate directory publishing affiliate, including the

recent case before the Washington Utilities and Transportation Commission addressing imputation of (then) US WEST yellow pages revenues.

Summary

3. The BOCs' market power in the local market allows them to set prices at supracompetitive levels both for retail end user services as well as for the wholesale essential bottleneck services that constitute critical inputs to the local and long distance services being provided by CLECs and IXCs. Although BOCs and other ILECs have been required to open their markets to local competition since the passage of the *Telecommunications Act of 1996* some seven-and-one-half years ago, CLEC entry has been extremely limited, and in any event has failed to provide competitive pressures sufficient to constrain incumbent carrier prices and conduct. Nationally, CLECs have achieved only a 13% local retail market share, and the inflation adjusted price of local telephone service continues to rise. According to the latest FCC *Local Competition Report*, ILECs still control at least 96.6% of all local exchange service facilities either as their own retail services or as the underlying wholesale services furnished to CLECs.

4. The "carrot" of long distance reentry by the BOCs, intended by Congress to spur them into opening their network, was not successful in incenting the BOCs to comply fully with the unbundling, interconnection and pricing requirements of Sections 251 and 252. As a result, local competition remains minimal, and BOC dominance of the local market remains both undiminished and essentially unchallenged. Although the principle underlying the Section 271 long

distance reentry was that the development of local competition would limit the BOCs' ability to extend their local service monopoly into the adjacent long distance market, the absence of effective competition for local services has failed to achieve that outcome. This continuing local market power in the retail, wholesale and carrier access markets, coupled with their ability to jointly market local and long distance services to their near ubiquitous base of legacy monopoly customers, affords the BOCs the unique ability to rapidly come to dominate all interstate and intrastate, interLATA and intraLATA long distance service.

5. While the FNPRM focuses primarily upon the *interstate* long distance market, BOC pricing and packaging practices have eradicated any distinction between interstate and intrastate long distance services from the customer's perspective. Customers cannot make separate choices of interstate and intrastate long distance carrier, and are being offered service bundles that merge the separate regulatory jurisdictions into a unified service and pricing plan. At the same time, intrastate access charges remain at multiples of the corresponding interstate level, and frequently *exceed* the retail price being charged for the intrastate component of the jurisdictionally undifferentiated retail long distance service. Additionally, BOCs are now bundling long distance service with local service packages, and are creating pricing plans under which the below-cost long distance rate component is cross-subsidized by the substantially-above-cost vertical service features that are included within these bundles. These pricing practices work to alter, at its most fundamental level, the long distance service paradigm, ultimately forcing interexchange carriers that do not also provide the customer's local service out of the market. And, since the BOCs maintain overwhelming dominance over the *local* service market, the

elimination of stand-alone long distance service providers will necessarily result in BOC remonopolization of the long distance market as well.

6. The Commission's previous reliance in the *LEC Classification Order* upon the separate affiliate requirements of Section 272 to forestall BOC anticompetitive conduct during the first three years following long distance entry in a given state has now been shown to have been seriously misplaced. There is significant evidence from the Section 272 Audits and from BOC revealed conduct that, as implemented, these requirements have failed to protect competitors from BOC anticompetitive acts. If classified as dominant carriers, BOCs will be compelled to file detailed cost support and other data and documentation in connection with their tariffs and prices, and to affirmatively demonstrate that any proposed rates or rate changes are compliant with all applicable imputation, cost allocation, cost recovery, and nondiscrimination requirements. The BOCs' incentives to misallocate costs of functions that jointly support both their local and long distance operations, and in so doing to benefit their competitive services at the expense of monopoly customers, are substantial, and there is substantial evidence that the BOCs have persistently engaged in such conduct, even with the separate affiliate requirements of Section 272 in place. Treatment of the BOCs as dominant carriers will permit the Commission to monitor and thus to assure BOC compliance and, so long as the BOCs are in compliance, will not subject them to consequential costs or burdens.

7. The BOCs' dominance of the local market assures their continuing dominance of the wholesale access services market as well. Prior to their reentry into the long distance market,

BOCs did not compete with purchasers of their monopoly access services (i.e., with IXCs), but they now do. The continuing practice of pricing carrier access services at multiples of incremental cost — which is particularly prevalent at the state level — affords the BOCs an enormous competitive advantage by allowing them to simultaneously raise their rivals' costs while enabling them to price their own retail long distance services below the level of access charges, imposing a price squeeze upon competing IXCs. At a minimum, dominant carrier regulation must be maintained at least for so long as access charges remain at these excessive levels.

8. BOCs have made extraordinary and unprecedented market gains following their receipt of Section 271 in-region long distance authority, and SBC, for one, has predicted an end-state retail market share of 60% based upon its actual experience in Connecticut, where long distance entry was never conditioned upon the requirement that SBC (or its predecessor, SNET) satisfy the Section 271(c)(2)(B) "competitive checklist." That outcome, if extended nationally, create a strong likelihood that the BOCs will possess sufficient market power to be able "profitability to maintain prices above competitive levels for a significant period of time." Without the safe-guards that can be maintained only through dominant carrier treatment, BOCs will have both the incentive and the ability to engage in predation, and to permanently increase their prices once their rivals are forced out of the market.

THE BOCS HAVE BOTTLENECK MARKET POWER

The BOCs' tremendous market power in the local market allows them to raise both retail end user prices as well as the wholesale prices of the essential bottleneck services relied upon by CLECs to compete.

9. The FCC has defined market power as, *inter alia*, "the ability to raise and maintain price above the competitive level without driving away so many customers as to make the increase unprofitable."[1] In a competitive, multi-firm market, consumers are able to shift their purchases easily among the various suppliers in response to any unilateral action by any individual firm to raise its price above the competitive market level. Under these conditions, consumers can be expected to respond to a price increase initiated by any one firm by rapidly shifting their business to another provider whose prices have remained stable. As a result, the attempt by the first firm "to raise and maintain price above the competitive level" will not be successful, and could not be sustained.

10. While BOCs have repeatedly claimed that they confront competition in the local market — and have sought to support those contentions with "head counts" of purported "competitors" — at bottom there has never been any demonstration that BOCs are *not* able "to raise and

1. *Competitive Carrier Fourth Report and Order,* 95 FCC 2d at 558, at para. 8 (citing *inter alia* W.M. Landes & R.A. Posner, *Market Power in Antitrust Cases*, 94 Harv. L. Rev. 937, 937 (1981), and A. Kahn, *The Economics of Regulation* 65-66 (1970)). The 1992 Department of Justice/Federal Trade Commission Merger Guidelines similarly define market power as "the ability profitability to maintain prices above competitive levels for a significant period of time." 1992 Merger Guidelines, at 20,570.

maintain price above the competitive level without driving away so many customers as to make the increase unprofitable." To the contrary, while feigning competitive pressures, BOCs have frequently *raised their prices* when given the "pricing flexibility" to do so.[2] Hence, there is no basis for the Commission to find that there has been *any* consequential diminution of BOC market power in the local services market since the date of enactment of the 1996 law.

11. The BOCs' ability to raise prices — particularly for "mass market" services — without driving away customers is a direct result of their overwhelming dominance of the local exchange market. The FCC's just-issued *Local Competition Report* for end-of-year 2002 puts the ILEC share of access lines, including resale and UNE services provided to CLECs, at 96.6%.[3] According to the FCC *Local Competition Report*, some three-quarters of all CLEC lines utilize underlying services and facilities obtained from ILECs and, although not specifically addressed by the FCC study, that percentage is undoubtedly even higher for CLEC mass market residential and small business customers.[4] In fact, the ILEC facilities-based share is actually *greater* than

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2. *See, AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Service*, RM 10593, *Petition*, filed October 15, 2002.

3. FCC, Wireline Competition Bureau, Industry Analysis and Technology Division, *Local Telephone Competition: Status as of December 31, 2002*, Rel. June 12, 2003, ("*Local Competition Report*") at Tables 3&4. Calculation was made using the ILEC total lines from Table 4 (which includes ILEC end user lines, resold lines and UNEs) divided by the sum of ILEC total lines and CLEC-owned lines (from Table 3).

4. As I noted in my January 23, 2003 Declaration in RM 10593, *In the Matter of AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier*
(continued...)

the sum of resale-plus UNE-based CLEC services cited above, because CLECs also make extensive use of ILEC-provided special access services to serve their small- and mid-sized business customer premises.

12. The same *Local Competition Report* notes that at the close of 2002 CLECs nationally had only a 13% local market share, and some 31% of US zip codes lacked even a single competitive local provider.[5] Despite BOC claims that their entry into the interLATA market is the catalyst that will stimulate CLEC entry, the "facts on the ground" do not come even remotely close to supporting that contention. For one thing, even for those states in which CLEC retail penetration is highest, the penetration of *facilities-based* competitive services is minimal. According to FCC data, for the forty-two states (and the District of Columbia) in which in-region long distance entry has been permitted (plus Connecticut and Hawaii, where no such authority was required), BOCs (and, in the case of Connecticut and Hawaii, non-BOC ILECs) provide the underlying facilities for roughly 86.6% of all residential lines (see Table 1).

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4. (...continued)
Rates for Interstate Special Access Services, at para. 18, AT&T currently provides service at approximately 186,000 commercial buildings. Of these, AT&T *owns* facilities to only about 6,700 buildings, and obtains facilities *from other CLECs* at approximately 3,300 additional locations. Thus, competitive alternatives to ILEC special access service are available at only about 10,000 locations, representing roughly 5.7% of the approximately 186,000 commercial buildings at which AT&T currently provides service, and at less than 0.4% of the 3- to 4-million commercial buildings nationwide.

5. FCC *Local Competition Report*, December 2002), at Tables 6 and 14.

Table 1

CLEC-Reported End-User Switched Access Lines by State
(As of December 31, 2002)

State	Total CLEC Lines	Total CLEC Lines Served Over ILEC Facilities	End-User ILEC Access Lines	Total Access Lines	ILEC Lines as a Percent of Total Lines
Alabama	187,320	166,144	2,238,352	2,425,672	92.28%
Arkansas	144,411	95,431	1,257,291	1,401,702	89.70%
California	2,698,705	1,807,673	21,475,881	24,174,586	88.84%
Colorado	482,014	275,450	2,642,166	3,124,180	84.57%
Connecticut	236,462	131,417	2,263,446	2,499,908	90.54%
Delaware	*	*	525,447	*	*
District of Columbia	160,174	93,673	831,920	992,094	83.85%
Florida	1,495,132	1,165,488	10,406,129	11,901,261	87.44%
Georgia	780,970	611,428	4,423,324	5,204,294	84.99%
Hawaii	*	*	723,111	*	*
Idaho	*	*	700,089	*	*
Iowa	201,176	164,007	1,329,633	1,530,809	86.86%
Kansas	258,312	211,992	1,236,051	1,494,363	82.71%
Kentucky	92,483	42,819	2,100,313	2,192,796	95.78%
Louisiana	188,652	151,096	2,353,620	2,542,272	92.58%
Maine	*	*	750,749	*	*
Maryland	285,416	261,641	3,502,515	3,787,931	92.47%
Massachusetts	750,473	384,471	3,750,998	4,501,471	83.33%
Minnesota	572,708	420,086	2,708,221	3,280,929	82.54%
Missouri	336,895	266,760	3,145,872	3,482,767	90.33%
Montana	*	*	509,979	*	*
Nebraska	177,698	62,602	828,394	1,006,092	82.34%
Nevada	163,520	128,428	1,348,042	1,511,562	89.18%
New Hampshire	125,893	66,485	723,653	849,546	85.18%
New Jersey	682,249	603,693	5,883,106	6,565,355	89.61%
New Mexico	*	*	965,816	*	*
New York	3,190,192	2,748,731	9,646,157	12,836,349	75.15%
North Carolina	405,853	329,164	4,824,385	5,230,238	92.24%
North Dakota	*	*	293,639	0	0.00%
Oklahoma	207,798	93,454	1,726,359	1,934,157	89.26%
Oregon	183,319	138,007	1,955,544	2,138,863	91.43%
Pennsylvania	1,405,894	867,493	7,167,204	8,573,098	83.60%
Rhode Island	145,202	55,043	526,143	671,345	78.37%
South Carolina	161,121	151,484	2,210,548	2,371,669	93.21%
Tennessee	326,663	226,283	3,147,556	3,474,219	90.60%
Texas	2,182,929	1,756,761	10,766,127	12,949,056	83.14%
Utah	194,352	103,089	1,075,061	1,269,413	84.69%
Vermont	*	*	383,758	*	*
Virginia	639,330	364,102	4,262,823	4,902,153	86.96%
Washington	406,750	228,457	3,553,994	3,960,744	89.73%
West Virginia	*	*	950,564	*	*
Wyoming	*	*	251,672	*	*
Total	19,470,066	14,172,852	131,365,652	150,835,718	87.09%

Note: States marked with an * had CLEC line figures too low to maintain firm confidentiality. These numbers are assumed to be zero.
Source: *FCC Local Competition Report,* Tables 9-10.

13. New York, the most frequently cited example of "robust" local competition, is still struggling with BOC local market power, and CLEC growth has slowed to a snail's pace despite favorable UNE rates.[6] A report including an analysis of local competition presented recently by the staff of the New York Public Service Commission (NYPSC) indicates that CLEC penetration rates in New York actually *decreased* in the second quarter of 2001, suggesting that the initial CLEC gains following Verizon's interLATA entry could not be sustained.[7] The NYPSC staff attributes this drop to poor performance in the CLEC capital market, to UNE pricing problems, and to a myriad of small obstacles placed by Verizon upon CLEC competitors attempting to interconnect with or secure facilities from the BOC.[8] The FCC's most recent *Local Competition Report* confirms the NYPSC staff's conclusion, noting that the New York CLEC market share has remained at 25% for the last year and a half.[9]

14. Access line facilities are not fungible from one location to another: The fact that a CLEC might own facilities serving some specific buildings in a particular zip code does not

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6. *Proceeding on Motion of the Commission to Consider Cost Recovery by Verizon and to Investigate the Future Regulatory Framework*, NYPSC Case 00-C-1945, *Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements*, NYPSC Case 98-C-1357, *Order Instituting Verizon Incentive Plan*, New York Public Service Commission, February 27, 2002.

7. New York Public Service Commission, *In the Matter of Verizon–New York*, Case No. 00– C– 1945, Report of Commission Staff, February 2002, at 18-19.

8. *Id.*

9. *Local Competition Report*, at Table 7.

make such CLEC-owned facilities available ubiquitously throughout that — or any other — zip code. ILECs clearly possess “the ability to raise and maintain price above the competitive level without driving away so many customers as to make the increase unprofitable” precisely because the *supply elasticity* confronting CLECs is extremely low. CLECs cannot rapidly respond (or in most cases cannot respond at all) to an ILEC price increase by expanding their own facilities, which is the only condition (short of regulation) that would be capable of constraining an ILEC price increase. BOCs must continue to be classified as *dominant* carriers with respect to *any service* that is linked to the access line platform, *including and especially any long distance services that are bundled with basic exchange service under a single pricing package*.

15. The BOCs seek to attribute the persistently low CLEC supply elasticity to what the BOCs claim to be UNE rates that do not cover their costs. SBC, for example, contends that were UNE rates to be increased, CLECs would then invest in their own facilities.[10] However, evidence recently offered *by SBC* to the United States District Court for the Northern District of Illinois, Eastern Division,[11] directly belies this contention.

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10. *See, e.g. Voices for Choices et al v. Illinois Bell et al*, Before the US District Court for the Northern District of Illinois Eastern Division, No. 03 C 3290, (“*Voices for Choices et al v. Illinois Bell et al*”) Affidavit of Debra J. Aron on Behalf of SBC Illinois, filed May 27, 2003 (“*Aron affidavit*”).

11. *Voices for Choices et al v. Illinois Bell et al*, Affidavit of Randall S. White on Behalf of SBC Illinois, filed May 27, 2003 (“*White affidavit*”).

16. In the Illinois case, SBC affiant Randall C. White confirms that CLECs' apparent failure to deploy facilities of their own is not *caused* by what SBC seeks to portray as "subsidized" UNE prices, but rather is due to the *enormous cost* that a CLEC would be forced to incur to deploy its own distribution network, when expressed on a per-customer basis. Mr. White explains that "[o]utside plant represents the largest capital and expense category in SBC Illinois' operating budget."[12] Were a CLEC to engage in its own outside plant facilities construction, that same condition would surely apply to the CLEC as well. Mr. White explains that

> ... distribution plant is sized to meet the long-term ultimate demand of residence and business customers within a specific geographic area. Unlike feeder cables, distribution cables are not as readily accessible. ... Therefore, distribution facilities in urban/suburban areas are sized to meet the expected long-term ('ultimate') demand for telecommunications facilities in that neighborhood.[13]

While this "meet ultimate demand" engineering requirement means that SBC will typically deploy more loops along a given street or in a given subdivision than there are (current) lines in service, an ILEC can nonetheless generally count on providing *at least one line,* either at retail or as a UNE, to virtually 100% of the existing and future households along the distribution cable route. That is not the case with an individual CLEC. For example, SBC Illinois currently serves

12. *Id.*, at para. 14.

13. *Id.,* at para. 19.

some 5.97-million network access lines in the state.[14] According to SBC, there are currently 54 CLECs providing service in Illinois, of which only seven currently serve in excess of 35,000 access lines.[15] The largest CLEC in Illinois serves only about 6% of that 5.97-million, largely via UNE-Loops or UNE-P.[16] Of the remaining 47 small CLECs, the largest of these serves no more than 35,000 lines, or no more than 0.6% of the SBC Illinois total. Mr. White states that "[s]izing distribution facilities ... to accommodate long-term [ultimate] demand is a standard practice in the telecommunications industry."[17] Thus, any CLEC undertaking to construct its own distribution facilities would necessarily have to size its cables on the same basis — i.e., to satisfy ultimate demand in the area being served.[18] So if a particular neighborhood requires

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14. ARMIS, Report 43-08, Table 2, *Switched Access Lines in Service, Year-end 2002,* "Total Switched Access Lines" column.

15. *Aron affidavit*, at para. 71.

16. *Id.*

17. *White affidavit*, at para. 22.

18. One might argue that for a CLEC the correct engineering standard is "ultimate *expected* demand" rather than "ultimate [total] demand." Even in that case, however, the CLEC's cost would not be proportionately lower. As SBC's Mr. White expressly notes, "[t]he most costly element in installing outside plant facilities is the labor, not the plant itself, and labor costs increase over time. For example, for any given job, installation labor costs represent more than 70% of the total cost." *White affidavit*, at para. 39. Since installation labor is not materially impacted by the physical size (capacity) of the cable being installed, a CLEC constructing distribution facilities based upon *its* ultimate expected demand (assuming, say, an ultimate 20% market share) would *at the very most* save 80% of the 30% of *non-labor* costs, i.e., that job would still cost about 76% of what the BOC would spend. However, many of those costs — such as supporting structures, rights-of-way, and construction equipment — are also fixed relative to cable size. Hence, even if the CLEC were to build capacity only to serve its own
(continued...)

deployment of 1,000 loops to satisfy ultimate demand, a facilities-based CLEC would need to undertake that same 1,000-loop build that would apply for SBC Illinois. SBC's average distribution fill in Illinois is 41%.[19] So, on average, for a 1,000-pair distribution loop facility that SBC Illinois constructs, it can expect to put about 410 pairs into revenue-producing service.

17. Now consider the conditions that a facilities-based CLEC would confront in order to serve the same neighborhood. It would need to build a similarly-sized facility (i.e., 1,000 loops) to meet ultimate demand; even if it were to deploy a smaller capacity distribution cable, its costs would not be substantially lower. However, unlike SBC Illinois, it could not count on serving on average the 410 revenue-producing lines. The largest CLEC, with a roughly 6% share, could only count on serving, on average, about 25 lines out of the 1,000-pair facility; a small CLEC, with a 0.6% share, could only expect to serve, on average, about 2.5 lines out of the 1,000 pairs that it would need to deploy. Assuming that the CLECs' construction costs are in all other respects comparable to those of SBC Illinois,[20] the largest (6% share) CLEC would incur a

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18. (...continued)
ultimate expected demand, its total costs would not be materially different from the BOCs' *but its per-loop cost would be many multiples thereof.*

19. *Aron affidavit*, at para. 29.

20. The costs of facilities construction confronted by any individual CLEC are likely to be considerably higher for an otherwise comparable project than those that SBC Illinois would incur, due to the CLEC's considerably smaller size and purchasing power. In addition, because any individual CLEC will necessarily confront far greater competitive risk than the market dominating SBC Illinois, its risk-adjusted cost of capital will be a good deal higher, assuming of course that the capital is available to the CLEC in the first place.

capital construction cost per *revenue-producing* loop that is some *16 times* what SBC would confront for each revenue-producing loop that it deploys. A small (0.6% share) CLEC would confront per-working-loop costs that are some 164 times that which SBC pays. And CLECs that are even smaller than the 35,000-line level would confront even higher multiples of SBC's costs were they to undertake facilities construction of their own. Thus, the BOCs' local market power is currently, and shall remain for the foreseeable future, intact. CLECs are not investing in their own subscriber loops because the cost of doing so is prohibitively expensive, not because the TELRIC-based price that the BOCs are required to charge for UNEs is "too low" or is being "subsidized" as the BOCs pejoratively claim. Indeed, SBC's evidence provides compelling support of the inescapable *fact* that with limited exceptions involving high concentrations of CLEC customers in densely-populated central business districts of major cities, subscriber loops are a "natural monopoly" by any traditional standard.

18. Resale CLECs have even less ability to compete with the BOC, even *and especially* when the BOC raises its retail prices. Pricing of "resale" services is, of course, directly linked with the BOC's *retail* price (which, pursuant to 47 U.S.C. 252(d)(3), are set "on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier"). If an ILEC raises its retail prices, it concurrently and correspondingly raises its wholesale resale prices as well, forcing resellers to make lock-step adjustments in their own retail rates. Although UNE rates are not set specifically in relation to the BOCs' retail prices, UNE rates and UNE availability, of course, continue to be the subject of

considerable controversy, and the sustained economic viability of *any* CLEC business plan premised upon the ongoing availability of ILEC facilities is anything but certain. The BOCs' ability, as an economic matter, to set UNE and resale prices at supracompetitive levels arises directly from the utter lack of competitive supply of the underlying local service facilities. As the Commission's *Local Competition Report* confirms, the vast majority of CLEC services are furnished by means of resold ILEC services and UNEs, and the figure would be even high if special access facilities acquired from ILECs are included. CLECs do not even have the physical capacity to serve more than a small fraction of their existing retail demand, and they certainly would have no ability to rapidly expand their facilities in response to increased BOC prices. This near-zero CLEC supply elasticity affords the BOCs the ability to control and limit output in the downstream market by raising the costs of downstream competitors' inputs, which also forces retail prices being charged by downstream firms to be higher than they would otherwise be. This, in turn, provides the BOCs with a price umbrella for their own retail services, resulting in higher BOC rates and reduced BOC output as well. Thus, while there might (perhaps) be sufficient competitive alternatives for the (at most) 3.4% of access lines that are being served via CLEC-owned facilities, *for the 96.6% or more of the lines that are furnished by means of ILEC-owned facilities* the only way in which the ILEC will experience a net loss of business as a result of a price increase is in the exceedingly rare situation in which the customer elects to do without local telephone service altogether.

19. The BOCs' local market power has not diminished since 1997. When considering the bundling of services in March 2001, the Commission again found that BOCs retain market

power in the local exchange market, and based its policy upon the conclusion that Section 272 provided a check on the ability of a BOC to leverage its local market power into adjacent markets:

> Despite the inroads made by competitors into the local exchange market that we described above, incumbent LECs retain market power in the provision of local service within their respective territories. Thus, unlike our previous analysis of the interexchange market or nondominant LECs, incumbent LECs possess one of the essential characteristics for engaging in anticompetitive behavior — market power with respect to one of the components in the bundle. Nonetheless, we conclude, in light of the existing circumstances in these markets, that the risk of anticompetitive behavior by the incumbent LECs in bundling CPE and local exchange service is low and is outweighed by the consumer benefits of allowing such bundling. We view the risk as low not only because of the economic difficulty that even dominant carriers face in attempting to link forcibly the purchase of one component to another, *but also because of the safeguards that currently exist to protect against this behavior*.[21]

20. As recently as July 15 of last year, FCC Chairman Michael Powell was quoted in *The Wall Street Journal* reiterating the conclusion that BOCs have been slow to lose their market power in the local market: "We correctly believed these markets didn't need to be natural

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21. *In the Matter of Policy and Rules Concerning the Interstate, Interexchange Marketplace; Implementation of Section 254(g) of the Communications Act of 1934, as amended*; CC Docket No. 96-61; *1998 Biennial Regulatory Review — Review of Customer Premises Equipment And Enhanced Services Unbundling Rules In the Interexchange, Exchange Access And Local Exchange Markets*, CC Docket No. 98-183, *Report and Order*, Rel. March 30, 2001, 16 FCC Rcd 7418, 7438, emphasis supplied. At 16 FCC Rcd 7434, the Commission specifically notes Section 272, *inter alia*, as providing sufficient protection against the market power of the BOCs.

monopolies and they could be competitive, but I think we tended to over-exaggerate how quickly and how dramatically it could become competitive."[22]

21. The FCC is not alone in remaining concerned about BOC local market power and its potential anticompetitive effects. The New York PSC found that Verizon New York remains dominant in the special services (i.e., UNEs and special access) market:

> Verizon's data, as well as the advantages attendant upon its historical incumbent position, indicate it continues to occupy the dominant position in the Special Services market, and by its dominance is a controlling factor in the market. Because competitors rely on Verizon's facilities, particularly its local loops, Verizon represents a bottleneck to the development of a healthy, competitive market for Special Services. In this situation, regulation is needed to assure the development of competitive choices, and good service quality when choices are not available. Accordingly, we find that a competitive facilities-based market for Special Services has yet to emerge and that Verizon continues to dominate the market overall.[23]

CLECs and IXCs depend heavily upon BOC special services in order to furnish retail local and long distance services to their own customers. By virtue of their control over these bottleneck

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22. "FCC's Powell Says Telecom 'Crisis' May Allow a Bell to Buy WorldCom," *The Wall Street Journal*, July 15, 2002, at A1, A4.

23. *Proceeding on Motion of the Commission to Investigate Methods to Improve and Maintain High Quality Special Services Performance by Verizon New York Inc.*, Case 00-C-2051, *Proceeding on Motion of the Commission to Investigate Performance-Based Incentive Regulatory Plans for New York Telephone Company*, Case 92-C-0665, before the New York Public Service Commission, *Opinion and Order Modifying Special Services Guidelines for Verizon New York Inc., Conforming Tariff, and Requiring Additional Performance Reporting*, June 15, 2001, at 9.

facilities, BOCs are in a position to restrict the availability of these essential services to their rivals. If the special services market were competitive, the creation of artificial limitations on service availability would not be possible. The Indiana Utility Regulatory Commission recently concluded:

> However, we cannot ignore the potential negative consequences or anti-competitive effects that could flow from an unrestricted grant of authority to an affiliate of the largest ILEC in Indiana. The conditions that are ordinarily imposed on facilities-based carriers are only a starting point as those conditions were designed primarily for CLECs. This docket involves certification of an affiliate of the largest ILEC in the state. This Cause also involves an affiliate intending to use advanced technology and investment in the public network for the provision of advanced services. Ameritech Indiana as the dominant local exchange provider has the incentive and capability to exercise market power.[24]

The Montana PUC echoed Indiana's concern:

> The Commission is sympathetic to the concerns expressed by the parties and recognizes that the competitive local exchange market will likely create opportunities for customers to obtain services from alternate providers even though they may have delinquent accounts with a competitor. This will be a change for the incumbent LEC which has been the only provider of telecom-

24. *In the Matter of the Petition of Ameritech Advanced Data Services of Indiana, Inc. (Which Is In the Process of Adopting the Business Name of SBC Advanced Solutions, Inc.) For A Certificate of Territorial Authority to Provide Facilities-based and Resold Telecommunications Services Throughout the State of Indiana and Requesting the Commission to Decline to Exercise Jurisdiction Pursuant to I.C. 8-1-2.6*, Indiana Utility Regulatory Commission Cause No. 41660, *Opinion*, 2001 Ind. PUC LEXIS 275, approved May 19, 2001, at *39-*40.

munications service in the past and which still has near total market power, particularly in rural states like Montana.[25]

22. Raw data purporting to quantify the extent of CLEC market penetration that has been offered by BOCs in various Section 271 proceedings is, at a minimum, highly controversial[26] and does not establish that competition exists "on the ground" at a level that offers consumers a realistic alternative to the BOC's services or that works to limit or constrain the BOC's market power.

25. *In the Matter of the Application of Citizens Telecommunications Company of Montana and CommSouth Companies, Inc., Pursuant to Section 252(e) of the Telecommunications Act of 1996 for Approval of Their Resale Agreement*, Montana Public Service Commission, Utility Division Docket No. D2000.7.104; Order No. 6281, *Final Order*, Montana Public Service Commission, 2000 Mont. PUC LEXIS 121, October 16, 2000, at 13.

26. In seeking to quantify the extent of CLEC market presence, BOCs have relied upon CLEC E911 database entries adjusted to exclude UNE-Loops, as indicative of the number of CLEC facilities-based lines. But E911 database records are keyed to *telephone numbers*, not telephone *lines*, and in the case of multiline business customers the quantity of individual telephone numbers may be a multiple of the number of individual lines. In addition, BOCs have typically not excluded from the E911 "number counts" non-UNE BOC facilities that are being leased to CLECs such as and including Special Access lines. In fact, since CLECs are frequently unable to utilize UNE-loops to serve multiline business customers, the quantity of BOC Special Access facilities being leased by CLECs likely represents a substantial fraction — possibly even the *majority* — of CLEC-provided retail lines.

Attainment by a BOC of Section 271 in-region interLATA authority cannot be construed as demonstrating or implying that the BOC no longer has market power or that the local market in the state in which such authority has been granted has become competitive.

23. Section 271(c)) of the 1996 *Act* sets forth the specific requirements that a BOC must satisfy in order to obtain authority to provide in-region interLATA services. The BOC must, if applying under "Track A," demonstrate only that it has entered into at least one (1) interconnection agreement with a competing local service provider providing service (other than by resale of the ILEC's services) to residential customers and to business customers. The BOC must also satisfy a "checklist" of fourteen "specific interconnection requirements" that, for the most part, are reiterations of obligations that are imposed by Section 251 upon *all ILECs* separate and apart from any long distance entry *quid pro quo*.

24. At no point in the Section 271 process does the FCC apply its market power test. As interpreted by the FCC, Section 271 does not require a BOC to demonstrate that actual entry has occurred, that competing services are available generally throughout the state in question, or that the incumbent BOC has suffered or sustained any diminution of its preexisting market power.[27] In fact, the FCC has on several occasions *rejected* arguments, advanced by competing IXCs and

27. If the BOC is applying for Section 271 authority under "Track A" (i.e., Section 271(c)(1)(A)), it is only required to demonstrate that there is a minimum of just "one competing carrier" offering service to residential and to business customers in the state utilizing either the CLEC's own facilities or UNEs leased from the BOC. *In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Telecommunications Act of 1934, as amended, To Provide In-Region, InterLATA services In Michigan,* CC Docket No. 97-137, *Memorandum Opinion and Order*, Rel. August 19, 1997, 12 FCC Rcd 20543, 20598.

others, that a BOCs' continued dominance and pervasive control of the local market would make approval of its in-region interLATA entry contrary to the public interest notwithstanding its apparent satisfaction of the "competitive checklist."[28]

25. Inasmuch as the threshold conditions for the FCC's grant of in-region interLATA authority do not require the BOC to demonstrate, or the FCC to find, that *effective competition* has developed or that the BOC no longer has market power in the local market in a given state, the fact that a BOC has obtained Section 271 in-region interLATA authority cannot be construed as implying that it no longer has market power or that the local market in the state in which such authority has been granted — and particularly in all parts of that state — has become competitive. Indeed, in establishing the Section 272(a) and (b) separate affiliate requirements and the Section 272(c)) and 272(e) nondiscrimination requirements, Congress clearly sought to dissociate a BOC's satisfaction of Section 271(c)) with any finding or determination that it no longer had market power. On the other hand, Congress also understood that *if* the development of actual and effective competition in the local market were to occur, then the BOCs' market power could be diminished or perhaps even eliminated. But Congress had no illusions about that taking place immediately upon enactment of the 1996 law, immediately upon a BOC's receipt of Section 271 authority in a given state or, for that matter, even after a finite and predetermined interval of time following such grant. As the FCC has allowed Section 272 to sunset, non-

28. *See*, e.g., *In the Matter of the Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act To Provide In-Region, InterLATA Service in the State of New York*, CC Docket No. 99-295, *Memorandum Opinion and Order*, 15 FCC Rcd 3953, 4163 ("*Bell Atlantic New York Order*").

dominant interLATA treatment at a time when the BOC still maintains extensive market dominance and market power would be inconsistent with, and would therefore frustrate, the specific policy goals underlying the *Act.*

Experience in Connecticut and Hawaii belies any claims by BOCs that IXCs commence offering local service in a state as CLECs only after a BOC's receipt of Section 271 authority threatens their long distance market share.

26. The cases of Connecticut and Hawaii provide compelling examples that confirm the conclusion that BOC long distance entry cannot assure that the local service market will become competitive. At the time of the break-up of the former Bell System, two of the "Bell System" companies — The Southern New England Telephone Company ("SNET") in Connecticut and Cincinnati Bell, Inc. in Ohio and Kentucky — were only minority-owned by AT&T and were not required to be divested or made subject to the interLATA long distance line-of-business restriction that applied to all of the other Bell Operating Companies. AT&T voluntarily divested its remaining interest in both of these companies shortly after the break-up, and both were free to enter the long distance market at any time from 1984 onward. The GTE operating companies were not subject to the Bell MFJ line-of-business restriction, but became subject to a similar prohibition against long distance entry when GTE acquired a controlling interest in Sprint. However, the 1996 *Telecommunications Act* lifted the GTE long distance ban,[29] and the GTE companies were free to — and did — enter the long distance market as of the date of enactment,

29. 47 U.S.C. § 601(a)(2).

i.e., February 8, 1996. SNET, in fact, entered the Connecticut long distance market in 1993,[30] some *seven years sooner* than Verizon and SBC began offering such services in New York and Texas, respectively. Following enactment of the 1996 law and adoption of implementation rules by the FCC later that year, SNET and the GTE companies, all of which are ILECs as defined at 47 U.S.C. §251(h), were required to comply with the unbundling, resale, interconnection, and nondiscriminatory access to poles, ducts, conduit, operator services, directory assistance, directory listings as well as other the requirements of Sections 251 and 252 that I have previously enumerated. These obligations are very similar to the market opening requirements of Section 271(c)(2)(B), and when complied with by the ILECs *as they are required to do* would afford competitors the same ability to enter the local market in the *non-BOC* ILEC service areas as would prevail in BOC jurisdictions once the "competitive checklist" had been satisfied.

27. SNET is the dominant ILEC in Connecticut, and GTE (now Verizon) is the *sole* ILEC in Hawaii. If in fact there were any kind of *causal link* between ILEC long distance entry and the "stimulation" of local competition, one would expect to see rampant CLEC activity and market penetration in both of these states, as well as in such concentrated GTE (now Verizon) local service areas as southern California and the west coast of Florida. The facts speak otherwise. Studies by the FCC and others confirm that despite these ILECs' *early* long distance entry,

30. SBC Investor Briefing, *SBC Enters $7.7 Billion Texas Long-Distance Market*, July 10, 2000.

very little competitive *local* entry has occurred. The CLEC share in Connecticut is only about 9%, and CLEC activity is virtually nonexistent in Hawaii.[31]

28. Finally, the extraordinary difficulties that CLECs confront when attempting to compete with a BOC or other ILEC is compellingly demonstrated by the fact that the two largest BOCs — Verizon and SBC — have themselves failed to actively pursue out-of-region *local* market entry (as CLECs) *even after having specifically represented to the FCC that they would do so*. SBC, in its Joint Application for approval of its merger with Ameritech,[32] and Verizon, in its Joint Application for approval of its merger with GTE,[33] each represented that following their respective mergers the two mega-ILECs would each commit to pursuing "out-of-region" entry in various local exchange service markets. SBC had identified thirty such markets (of which 17

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31. *Local Competition Report*, at Table 6. Connecticut had just 9% CLEC end-user switched access lines; Hawaii's CLEC share was so small that it was not even included in the FCC report, with the explanation, "data withheld to maintain confidentiality."

32. *In re: Applications of Ameritech Corp., Transferor, and SBC Communications, Inc., Transferee, for Consent to Transfer Control of Corporations Holding Board Licenses and Lines Pursuant to Sections 214 and 310(d) of the Communications Act and Parts 5, 22, 24, 25, 63, 90, 95, and 101 of the Board's Rules*, Before the Federal Communications Commission, CC Docket No. 98-141, *Application* , Filed July 27, 1998 ("SBC/Ameritech Merger Application"), at Sec. II.A.1.

33. *Applications of GTE Corporation and Bell Atlantic Corporation, Description of the Transaction, Public Interest Showing and Related Demonstrations*, Before the Federal Communications Commission, CC Docket No. 98-184, *Application*, Declaration of Jeffrey C. Kissell, Filed October 2, 1998, ("*Bell Atlantic/GTE Merger Application*"), at para. 14.

were in what would become Verizon territory),[34] while BA/GTE (Verizon) committed to enter twenty-one markets.[35] Although various parties and their experts, including myself, were highly skeptical as to the legitimacy of these so-called "commitments," both sets of joint applicants insisted that their respective "national local strategies" would be aggressively pursued and would result in a significant enhancement of facilities-based local competition throughout the country.[36] In its Orders approving the two mergers, the FCC undertook to put some teeth into what were in other respects "soft" commitments on the part of the two sets of merger parties with respect to their out-of-region local entry plans. In its *SBC/Ameritech Order*, the Commission *required* SBC to undertake the promised out-of-region local entry, and indicated that the post-merger SBC would be fined as much as $39.6-million for *each* of the 30 out-of-region markets that it did not enter.[37] In the *BA/GTE Order*, the FCC similarly imposed the threat of fines if BA/GTE

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34. *SBC/Ameritech Merger Application*, Attachment A: "New Markets for the New SBC."

35. *Bell Atlantic/GTE Merger Application*, at para. 14.

36. *Id.*, at para. 15; *SBC/Ameritech Application*, Affidavit of James S. Kahan, at para. 27.

37. *In re: Applications of Ameritech Corp., Transferor, and SBC Communications, Inc., Transferee, for Consent to Transfer Control of Corporations Holding Board Licenses and Lines Pursuant to Sections 214 and 310(d) of the Communications Act and Parts 5, 22, 24, 25, 63, 90, 95, and 101 of the Board's Rules*, CC Docket No. 98-141, *Memorandum Opinion and Order*, October 6, 1999, at Appendix C, para. 59(d). The FCC ordered:

> If an SBC/Ameritech Out-of-Territory Entity fails to satisfy any of the 36 separate requirements for each out-of-territory market on or before the deadlines set forth in Subparagraph c, SBC/Ameritech shall make a one-time contribution of $1.1 million for each missed requirement (up to a total contribution of $39.6 million per market and $1.188 billion if SBC/Ameritech Out-of-Territory Entities fail to satisfy all 36

(continued...)

failed to invest at least $500-million in out-of-region CLEC activities, or provide service as a CLEC to at least 250,000 customer lines, by the end of 36 months following the merger closing date.[38] As it has turned out, of course, the skepticism of various commentors and the concerns of the FCC with respect to the veracity of these out-of-region local entry "commitments" were well-founded. Verizon and SBC/Ameritech's out-of-region entry pursuant to the merger conditions has been nominal and superficial, despite their pronouncements at the time of the merger that broad out-of-region entry would be aggressively pursued.[39] The decision by both SBC and

37. (...continued)
requirements in all 30 markets) to a fund to provide telecommunications services to under served areas, groups, or persons.

38. *Applications of GTE Corporation and Bell Atlantic Corporation, Description of the Transaction, Public Interest Showing and Related Demonstrations*, CC Docket No. 98-184, *Memorandum Opinion and Order*, Rel. June 16, 2000, at paras. 43-48.

39. Rory J. O'Connor, "Looser Reins," *eWeek*, March 26, 2001; "SBC Says It Meets Merger Terms Despite Out-Of-Region Cutbacks," *TR Daily*, March 20, 2001. In an obvious effort to escape the heavy fines that would otherwise apply, on March 5, 2002, SBC represented to the FCC that it is in compliance with its out-of-region entry commitments "for 16 of the required 30 markets," averring that "SBC Telecom, Inc. ("SBCT"), the SBC business unit with this responsibility, ... is offering local exchange service to all business customers and all residential customers throughout the areas in the market that are either (a) within the local service area of the incumbent RBOC located within the PMSA of the market or (b) within the incumbent service area of a Tier I incumbent LEC (other than SBC/Ameritech) serving at least 10 percent of the access lines in the PMSA ..." Letter dated March 5, 2002 to William F. Caton, Acting Secretary, FCC, from Carlyn D. Moir, Vice President, Federal Regulation, SBC Communications, Inc. SBC's representations to the Commission notwithstanding, the SBC Communications, Inc. website expressly indicates that service is available only in the thirteen in-region (i.e., SWBT, Pacific Bell, Ameritech and SNET) states (see fn. 74, *infra*.). Moreover, the SBC Communications, Inc. website, www.sbc.com, states that "SBC Communications, Inc. serves 20 of the largest U. S. markets," a figure that clearly does not include the out-of-region markets
(continued...)

Verizon to refrain from active pursuit of an out-of-region CLEC entry strategy suggests either that (a) both companies have concluded that such ventures will not be profitable due to the substantial economic barriers and other hurdles that they would each be required to overcome, or (b) the two companies have tacitly adopted a market allocation “agreement” in which each firm stays out of the other's territory. The first explanation clearly indicates the presence of substantial market power on the part of the incumbent LEC, while the second explanation would only be sustainable if entry by other CLECs is not a serious threat. Clearly, the two largest RBOCs, the two companies that possess more of both the resources and the technical/managerial/marketing experience and expertise that are needed to successfully pursue a CLEC-type entry than any other potential competitor, have elected (for whatever reason) not to challenge the dominant incumbent. If SBC and Verizon won’t compete with each other (and with other ILECs), it is patently unreasonable, if not altogether fanciful, to expect that *any other entrant* could so limit the incumbents’ market power that *as a policy matter* those incumbents could be afforded non-dominant treatment.

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39. (...continued)
purportedly being served by SBC Telecom, the SBC out-of-region CLEC business unit. Significantly, the SBC website does not even mention or provide a link to SBC Telecom; the only means by which a consumer would know about SBC's out-of-region local service offerings is by tracking down “SBC Telecom” specifically. Clearly, this “out-of-region” CLEC activity is barely on SBC's radar screen.

BOTTLENECK CONTROL ALLOWS THE BOC TO DOMINATE ADJACENT MARKETS

Control of the wholesale switched and special access bottleneck allows the BOCs to dominate all interstate and intrastate, interLATA and intraLATA long distance services.

29. When the Commission last addressed the question of whether BOCs should be considered "dominant carriers" with respect to their provision of in-region long distance services,[40] *none of the BOCs had as of that time obtained in-region long distance authority pursuant to Section 271 of the Telecommunications Act of 1996*. Thus, when the Commission determined that the BOCs were to be considered "non-dominant" with respect to in-region long distance services, their individual and collective share of the in-region long distance market was 0.0%. And, as I will discuss later, although the Commission obviously expected that BOC shares would increase (above zero) once in-region authority had been attained and in-region entry had occurred, it expressed the expectation that the various operational, accounting, personnel, and transactional safeguards set forth at Section 272(b), together with the imputation and nondiscrimination requirements at Section 272(e), would be sufficient to protect consumers and competitors from the undue exercise of BOC market power. Events have, of course, shown those expectations to have been unduly optimistic.

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40. *In the Matter of Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace*, CC Docket No. 96-149, 96-61, *Opinion*, Rel. April 18, 1997 ("*LEC Classification Order*"), 12 FCC Rcd 15756, 15,810-11; 15,815; 15,821-22; 15,825-27; 15,829, paras. 96, 103, 111, 119, 126.

30. The Commission has now acknowledged that many conditions have changed since its 1997 *LEC Classification Order*.

> There have been significant changes in the competitive landscape since the Commission adopted the *LEC Classification Order*, including: (1) BOC authority to offer in-region, interLATA telecommunications services in 41 states (plus the District of Columbia); (2) an increase in bundled telecommunications services offerings; (3) increased offerings of wide-area pricing plans by mobile telephony carriers; (4) limited, but increasing, substitution of mobile wireless service for traditional wireline service, particularly for interstate calls; and (5) increased use of Internet-based applications (e.g., instant messaging, email).[41]

These developments require that the considerations of BOC interLATA market power be considered in light of the manner in which the various services are being marketed to the public and the interactions between the various retail services and essential bottleneck wholesale services, principally switched and special access, for which the BOCs continue to maintain overwhelming market dominance.

31. With limited exceptions, the vast majority of "in-region" long distance services are linked to the retail customer's local basic exchange access line,[42] almost all of which continue to

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41. *FNPRM*, at para. 8, footnotes omitted.

42. The "exceptions" here are associated primarily with so-called "calling card" services that permit the customer to place long distance calls from public telephones and other local telephone service access lines without the call either being routed to the "presubscribed interexchanged carrier" ("PIC") associated with that line or billed to the customer of record for that access line for payment.

be provided by incumbent local exchange carriers, principally BOCs.[43] Mass market residential and small/medium size business customers typically gain access to long distance services via "common lines" that are, as the term implies, utilized jointly for both local and long distance calling. This recognition of the interaction between "in-region" long distance calling and the customer's local exchange access line was clearly recognized by Congress in enacting the 1996 law: BOCs were allowed *immediately* to enter the *out-of-region* long distance market as of the date of enactment,[44] but were required to satisfy the various provisions of Section 271 prior to being authorized to offer *in-region* long distance services.

32. BOC conduct commencing with the date of enactment of the 1996 law with respect to long distance entry serves to confirm and to underscore the extraordinary and unique business value of the *linkage* between the subscriber access line provisioned by the BOC and *the subscriber's* choice of long distance service provider. Although expressly *permitted* on and after February 8, 1996 to offer long distance services outside of their respective in-region footprints,

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43. According to the just-released *FCC Local Competition Report* for the year ending December 2002, nationally some 96.6% of all switched access lines were either being served directly by their ILEC or by a CLEC utilizing ILEC-provided facilities (resale or UNE). CLECs also utilize ILEC-provided special access to serve many of the CLECs' business customers, so the 96.6% ILEC facilities share identified in the *FCC Report* understates the actual percentage of access lines that are served via ILEC-owned facilities. For "mass market" residential and small business subscribers where few if any CLEC-owned facilities are deployed, the ILEC facilities share is undoubtedly a good deal higher. *Local Telephone Competition: Status as of December 31, 2002*, FCC, Industry Analysis and Technology Division, Wireline Competition Bureau, June 2003, at Tables 1, 3.

44. 47 U.S.C. §271(b)(2).

none of the BOCs elected to do so other than with respect to entirely *incidental* (primarily calling card and collect calling) services entirely unrelated to the subscriber access lines in such out-of-region areas. Out of region, a BOC long distance venture gains no particular competitive advantage from the BOC affiliation, and is thus not unlike any other non-BOC-affiliated IXC in terms of its ability to attract and retain customers. Had any of the BOCs chosen to actively pursue out-of-region long distance services, they would have been competing with the preexisting *non-BOC* interexchange carriers (e.g., AT&T, MCI, Sprint) *on essentially an equal basis*. Without their position as the "incumbent local exchange carrier," a BOC offering out-of-region long distance services would have had to engage in the same types of costly media advertising, direct mail, telemarketing, and promotions (such as sign-up payments or airline mileage offers) as did the non-BOC IXCs. *Without exception, none of the BOCs chose to focus on out of region long distance entry*. Indeed, even now, when BOCs have obtained Section 271 in-region authorization in some 42 states,[45] they still do not actively market services to local service subscribers outside of their own in-region footprints.[46] Hence, from the perspective of the BOCs and as amply demonstrated by their conduct, BOCs *only compete in-region*, where their local dominance and incumbency afford them competitive advantages and opportunities that no other IXC *or out-of-region BOC* can possibly hope to replicate.

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45. Having granted Section 271 authority in Minnesota on June 26, 2003, the Commission has now approved long distance reentry in 41 states, plus the District of Columbia.

46. In fact, SBC will not even *accept* an order for long distance service from a customer that is served by a non-SBC LEC (which includes both independent telcos *and* CLECs) *even within one of the thirteen states comprising the SBC "region." See* fn. 74, *infra.*

33. The real proof of the incumbency advantage is in the results. In the *FNRPM* herein, the FCC cited long distance market shares for the BOCs at between 0.2 and 9.3 percent.[47] However, such figures are misleading. Inasmuch as the BOCs do not actively compete out-of-region for long distance customers, the only *relevant* shares for purposes of the matters before the Commission in this proceeding are the BOC *in-region* long distance shares. Actual BOC market penetration results as reported by BOCs in states where in-region interLATA entry has been authorized demonstrate the dramatic and unprecedented success that the BOCs have achieved, often within mere months following their initial entry.

34. After approximately twelve months following its receipt of Section 271 authority in New York, Verizon Long Distance reported a New York residential share of 20%.[48] Nine months after receiving 271 authority in Massachusetts, Verizon reported a long distance share of more than 20%, and indicated that sales results for Pennsylvania, where Verizon began marketing long distance services in late October 2001, were in line with early success rates in other Verizon states.[49] In Texas, where SBC received interLATA authority in June of 2000,

47. *FNRPM*, at fn. 61.

48. See Verizon Press Release, "Verizon Communications Post Strong Results for Fourth Quarter and 2000," February 1, 2001.

49. See Verizon Press Release, "Verizon Communications Post Strong Results for Fourth Quarter, Provides Outlook for 2002," January 31, 2002.

SBC reported that after less than nine months its long distance affiliate, SBCS, had acquired 2.1-million of SWBT's 10-million local customers, representing a 21% share in the state.[50]

35. In a recent analyst conference call, SBC released the growth rates for its long distance services in states where it has received long distance authority (see Figure 1 below).

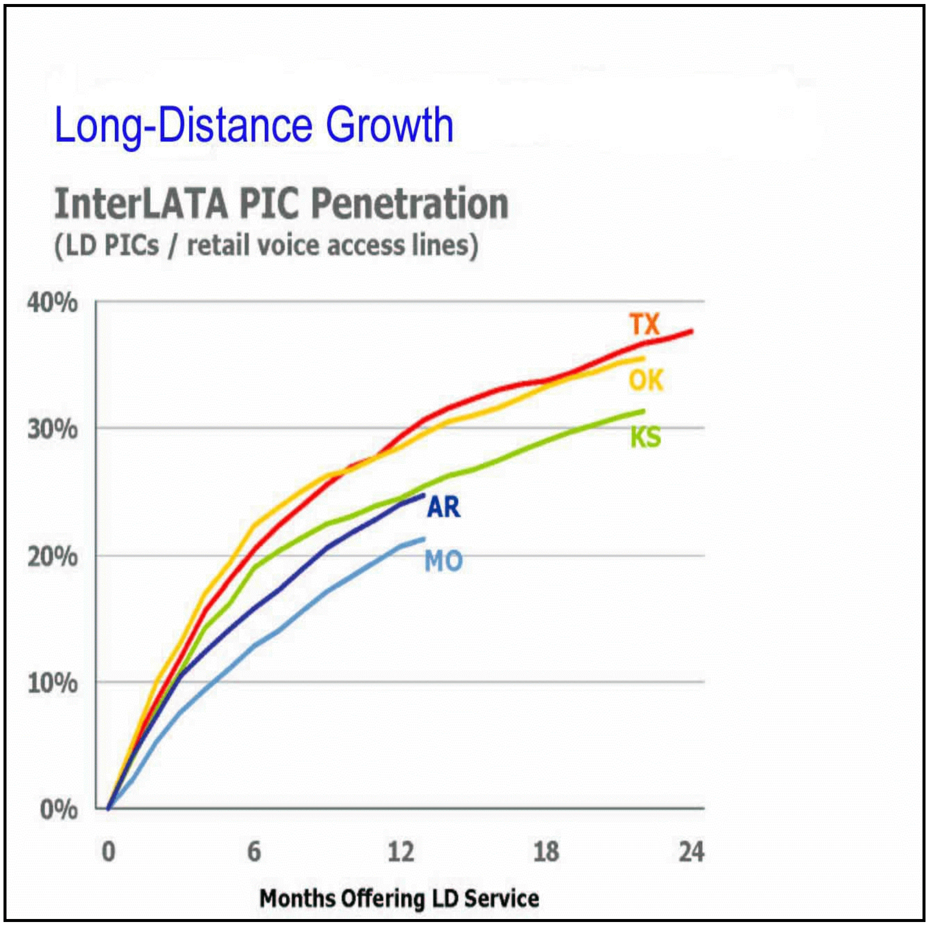

Figure 1. SBC Long Distance Growth

50. *SBC Investor Briefing*, April 23, 2001, at 7.

The following quarter, SBC announced that it has achieved "near 50 percent" penetration for the consumer long distance market in its Southwestern territories.[51] SBC has reported acquiring a 60% share of the Connecticut long distance services after approximately five years since SNET began actively marketing interLATA services, and has advised investors that a similar share can be expected for each of SBC's other Section 271 jurisdictions.[52] Some BOCs, including Verizon, have stopped releasing long distance share figures on a state-by-state basis, making further state-level analyses no longer possible. I urge the Commission to obtain the current state-by-state in-region long distance shares for each of the BOCs, even if this information cannot be publicly disclosed.

36. There can be no denying that there is an enormous distinction between "in-region" and "out-of-region" BOC dominance. In assessing the extent of BOC dominance, it is essential that for any given BOC, the geographic limits for purposes of market power analysis be no greater than that BOC's service area within a given state jurisdiction. And to further emphasize the importance of this "local service area" geographic definition, it is instructive to examine that same BOC's share of the long distance market both out-of-region *and* out-of-footprint within those states for which the BOC has attained Section 271 in-region authority.

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51. Statement of Edward Whitacre, CEO, SBC Communications, Transcript, April 24, 2003 SBC Conference Call Addressing First Quarter 2003 Earnings.

52. SBC Investor Briefing analyst conference call, January 28, 2003.

37. The stark contrast between each of the BOCs' extraordinary success in rapidly acquiring share (following its receipt of Section 271 authority) within its local service footprint vis-a-vis its utter absence from the market in areas served by other ILECs *within those very same states* confirms the critical importance to the BOCs of their ability to exploit legacy monopoly relationships with their existing base of local service subscribers as *the primary means* for rapidly acquiring customers for their long distance services. It also underscores the equally important point that where the BOCs do not possess this unique market advantage — i.e., where they would have to compete for long distance business on the same basis as their non-affiliated IXC rivals — *they don't even bother to try.*

BOC dominance and pricing strategies do not differentiate between interstate and intra-state jurisdictions, and for this reason the Commission cannot rationally limit its analysis to interstate services.

38. While interstate services may represent the limit of the Commission's traditional regulatory authority, from the customer's perspective any delineations or distinctions as between interstate and intrastate calling that may have existed in the past have become blurred almost to the point of sheer extinction. For starters, customers do not make separate choices as to interstate vs. intrastate long distance carriers. Only one interLATA "PIC" is available. A "common line" customer (residential or business) in Los Angeles who selects SBC as her presubscribed long distance carrier with respect to interstate calling will concurrently be choosing SBC for intrastate interLATA calls, such as from Los Angeles to San Francisco or San Diego, as well. Customers cannot and do not make separate service provider selections

notwithstanding the fact that the two services are subject to different regulatory treatment by different regulatory authorities and may be offered at different prices. Indeed, even the transactional distinction between intrastate and interstate interLATA calling (resulting from the treatment of each individual call as a distinct "purchase" of service) is in the process of being supplanted by service "bundles" that provide either flat-rate or "block-of-time" pricing for *combined* interstate and intrastate usage.

39. A case in point can be found in that portion of the recently-introduced service bundle that is being offered by Verizon's Section 272 affiliate, Verizon Long Distance ("VLD"). VLD is offering residential subscribers an unlimited intrastate/interstate interLATA-plus-Canada calling plan known as "Veriations Freedom℠" for a flat rate of $15 per month.[53] And unlike traditional by-the-call pricing, selection of the service bundle is accomplished in a single purchase transaction that remains in effect from month to month unless affirmatively discontinued by the customer. Not only does "jurisdiction" (state vs. interstate vs. international) have no bearing upon the manner in which the purchase transaction is effected, it also has no bearing upon the price that the customer is charged for the particular (jurisdictional) mix of calling that may be involved.

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53. Bell Atlantic Communications d/b/a Verizon Long Distance, RTC No. 1– Interstate, Section 3.6.10,fourth revised page 48.6, first revised page 58.7, first revised page 58.8, first revised page 58.0, original page 58.9.1, original page 58.9.2, all effective April 27, 2003; original page 58.10, effective January 27, 2003, second revised page 58.11, effective June 20, 2003.

40. Although "common line" customers are permitted, as a mechanical matter, to make separate selections of intraLATA and interLATA PICs, the introduction of long distance service bundles and block-of-time pricing plans by BOCs works to blur even this distinction as well. For example, in order for a customer to qualify to purchase the Verizon Long Distance $15-per-month interLATA "Veriations Freedom℠" service bundle, the customer is *required* to also purchase a "qualifying" package of "local" services that must include unlimited *intraLATA* calling.[54] Depending upon the state and package, these "qualifying" Verizon BOC packages are priced at between $34.95 and $54.95 per month.[55] Indeed, although a Verizon BOC customer is permitted to purchase the BOC local/intraLATA bundle *without also having to purchase the VLD $15-per-month interLATA bundle*, the packages are not separately marketed, and the customer would have to expressly specify the BOC local/intraLATA bundle during a phone contact with a Verizon (BOC) customer service representative in order to purchase it.[56]

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54. *Id.* Second revised page 58.11, effective June 20, 2003 states, "When service is used for both interstate and intrastate calling, the MRC specified below applies only once, unless otherwise stated in the corresponding tariff."

55. *See, e.g.* Verizon South, Inc. Virginia General Customer Services Tariff, section 16, original pages 17-18, effective February 3, 2003; Verizon New York, Inc. PSC NY No. 1, Section 2, original page 220, effective July 26, 2002, first revised page 221, effective February 1, 2003; original page 57, effective July 26, 2002.

56. The specific Verizon BOC "qualifying" local/intraLATA service bundles are not separately identified or disclosed on Verizon's website or in promotional direct mail materials being sent to Verizon subscribers (see Attachment 2). The billing insert included with June 2003 Verizon Massachusetts residential bills details certain rate increases for various *other* ("non-qualifying") service bundles, but makes no mention of the "Local Package Basic" or "Local Package Plus" bundles whose purchase is required for a customer to qualify for the VLD $15
(continued...)

41. SBC, BellSouth and Qwest do not even bother to make the facial distinction between their BOC and long distance affiliates with respect to their unlimited long distance calling bundles. Whereas Verizon has created a bifurcated offering, with the intraLATA service being provided by the BOC and the interLATA by the Section 272 affiliate, the other RBOCs' counterpart service bundles are in each case provided solely by the Section 272 long distance affiliate, and embrace both the intraLATA *and* the interLATA components. Customers selecting one of these bundles are required to select the Section 272 affiliate as both the interLATA PIC *and* the intraLATA PIC ("LPIC") in order to obtain the full benefit of the service bundle price.

42. In addition to the "common line," as an integrated local and long distance provider, the BOC also provides a common bill, without separate line items for local and long distance service, making it difficult for a customer to determine whether the price increase on her bill is a result of a local or long distance rate hike. The BOCs' market power in the local market assures that it could increase *local* rates without suffering a decrease in demand, and if the customer cannot determine if an increase is a *local* rate increase or a *long distance* increase, it follows that the

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56. (...continued)
unlimited interLATA/Canada offering. What is particularly noteworthy is that several of these other "non-qualifying" pricing plans whose rates are being increased actually provide *fewer features* that the "qualifying" packages (whose prices are not being increased), yet carry higher monthly rates. For example, Verizon's "Local Package Basic" (whose availability separate from the VLD $15 bundle is not generally disclosed) is priced at $39.95 and includes unlimited local and LATA-wide toll calling plus several vertical features (including call waiting and caller ID) The "Local & Toll Packages" (priced at $47.93 for western Massachusetts and $54.93 for eastern Massachusetts) include unlimited local and LATA-wide toll calling but *no vertical features*. The "Local Package – Metropolitan" includes some features but does not include LATA-wide calling, and is priced at $42.93 (see Attachment 2).

BOC's market power in the local market would enable the company to raise prices in *either the local or the long distance markets* if the services are jointly and indistinguishably billed.

The BOCs' can impose a price squeeze upon competing IXCs.

43. Prior to the BOCs' entry into in-region long distance, the purchase of local exchange service and the purchase of long distance service involved entirely separate and separable transactions; one's choice of service provider and pricing plan with respect to either one of these services had no bearing upon the choice or price of the other. That has now changed. Customers are being confronted with strong economic incentives to combine their acquisition of local and long distance telephone service into a single purchase transaction. BOCs and their long distance affiliates are marketing aggressively priced long distance plans — including plans providing *unlimited* nationwide long distance calling — but only to customers who *also* purchase relatively high-priced bundles of basic local exchange service and vertical calling features, such as call waiting, three-way calling, caller ID, and voice mail. Although similar local/long distance packages are also being offered by IXCs in those areas where the IXC also offers local service, the BOCs' persistent and overwhelming dominance of the residential/small business "mass market" affords them the unique ability to leverage their market power with respect to local services to rapidly come to dominate the long distance market as well.

44. Any assessment of the extent of BOC market dominance that is confined solely to the interstate jurisdiction would be woefully insufficient as a basis for policymaking. In its *ISP*

Remand Order,[57] the Commission has determined that the rate cap applicable for the termination by an ILEC of a local call handed-off to it by a CLEC is $0.0007 (i.e., seven one-hundredths of a cent) per minute, a rate that is presumably based upon the Total Element Long-Run Incremental Cost ("TELRIC") of that function.[58] Under the Commission's *CALLS* order,[59] the average target price for interstate terminating switched access is $0.0055 per minute, or roughly 700% above the TELRIC-based intercarrier reciprocal compensation rate *for what amounts to the identical service and functionality*. In the case of an interstate toll call carried by an IXC but originated from and terminated to BOC "common line" subscribers, the average *CALLS*-based access charge would be roughly $0.011 for both ends of the call. While still many multiples of the applicable TELRIC for that access service, the interstate access charge level is substantially less than that for corresponding *intrastate* switched access service which, in some cases, may be as much as ten times as high as in the interstate jurisdiction.[60]

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57. *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, Intercarrier Compensation for ISP-Bound Traffic, CC Docket No. 99-68, *Order on Remand and Report and Order*, Rel. April 27, 2001, at para. 85. The Commission explains that the $0.0007 rate was taken from an interconnection agreement between Level 3 and SBC. That agreement, which was effective March 2000 through May 2003, was presumably made in compliance with 47 U.S.C. §252(d), which the Commission has interpreted to require that rates for UNEs be based upon TELRIC.

58. *Id.*, at para. 8.

59. *Access Charge Reform*, CC Docket No. 96-262, *Sixth Report and Order*, eff. July 1, 2000, 15 FCC Rcd 12962.

60. Compared to a calculated Washington state intrastate access charge of $0.0989. *See*, *AT&T Communications of the Pacific Northwest v. Verizon Northwest, Inc.* Docket No. UT-020406, Before the Washington Utilities and Transportation Commission, Direct Testimony of
(continued...)

45. Consider Verizon Long Distance's unlimited interLATA tariffed service option.[61] VLD filed interstate and intrastate (where required) tariffs for this offering. However, the tariff filings fail to break down the charges for the separate interstate and intrastate jurisdictions. Both of these tariffs note that "[w]hen service is used for both interstate and intrastate calling, the MRC [monthly recurring charge] specified below applies only once."[62] Thus, from these tariff filings, it is impossible to determine whether the $15 unlimited plan satisfies imputation requirements.

46. Based upon the $0.011 *interstate* switched access payments that a non-BOC IXC would be required to make for each minute of interstate calling initiated by one of its customers and ignoring (for the moment) any *non-access* costs that the IXC might incur, that $15 would "buy" some 1363 minutes of (originating and terminating) interstate switched access. However, what if the only usage that the customer makes of that service is for *intrastate* calling in a state where *intrastate access charges* (originating plus terminating) average $0.10 per minute? In that case (and, again, ignoring for the moment any non-access costs that the IXC would necessarily incur),

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60. (...continued)
Lee L. Selwyn on Behalf of AT&T Communications of the Pacific Northwest, Inc., September 30, 2002, at Appendix 3.

61. Despite the sunset of the Section 272 separate affiliate requirement in New York, Verizon appears to continue to provide service in that state through the Verizon Long Distance entity. The Verizon Freedom plan for New York notes, "[y]ou must select and retain Verizon as your local provider, and Verizon Long Distance for long distance service." *See,* http://www22.verizon.com/Foryourhome/SAS/FreedomLongDesc.asp?ID=FLD&State=NY (accessed June 27, 2003).

62. See Attachment 2.

the $15 retail price would "buy" only 150 minutes worth of switched access service. An analysis as to whether Verizon's $15 price creates a price squeeze cannot be limited solely to the *inter-state* jurisdiction *precisely because Verizon does not offer a "stand-alone" interstate or jurisdictionally allocated version of this unlimited long distance calling bundle*.

47. In order to determine whether or not Verizon's price for unlimited long distance calling satisfies the applicable imputation and price floor requirements, it is necessary to know something about the level of usage that Verizon anticipates customers subscribing to the unlimited calling plan will make of the service. Verizon's tariff filings contain no publicly available information on this critically important point; however, it is possible to estimate Verizon's costs for this package. Usage level information is provided on Verizon's corporate website in connection with its marketing of the Veriations Freedom℠ package and in direct mail and other marketing literature promoting the service. Attachment 3 to this Declaration contains sample Verizon web pages describing the Veriations Freedom℠ service. In each of these state-specific web pages, Verizon advises its prospective Veriations Freedom℠ customers that they will realize "more than $240 a year in savings" (or slightly different words to that same effect) by signing up for the Veriations Freedom℠ package. Verizon has also sent direct mail solicitations to its customers containing the very same $240 in annual savings claim (see Attachment 2). Each of the individual state web pages, as well as the direct mail piece, contain the very same "fine print" text and, more importantly, the very same *usage levels*, as the basis for the $240 annual savings estimate:

> Savings based on purchasing Veriations Freedom Package versus purchasing equivalent Verizon local and long distance services and features at individual, standard rates. *Long distance savings comparison based on 350 minutes of monthly usage on Timeless Plan; regional toll savings based on approximately 300 minutes of monthly usage on Sensible Minute™ plan.* Savings vary by individual and by state.

Emphasis supplied. Note that, while Verizon does state (in the "fine print") that "[s]avings vary by individual and by state," its large print representation, at the top of each of the web pages and direct mail piece, is that customers will realize savings of "*more than* $240 a year." On this basis, it is reasonable to assume that the 300 minutes of intraLATA ("regional toll") calling and the 350 minutes of "Timeless Plan" interLATA calling represent *minimum* usage levels that Verizon anticipates for this service.

48. Using the $15 price for the unlimited interLATA calling bundle and the minimum usage level given of 350 minutes of interLATA calling as specified by Verizon, the average price per minute works out to roughly $0.043 for interstate and intrastate calling combined. While this $0.043 is above the $0.011 *interstate* switched access rate level, it is below the *intrastate* switched access rates in effect in a number of BOC jurisdictions — and even further below the average intrastate switched access charge applicable to non-BOC IXCs when the often-higher non-Bell ILEC and CLEC access charge levels are included in the analysis.[63] Like the parable

63. To the extent that BOCs limit the marketing of their long distance services to BOC local customers, the BOCs would be subject only to imputed access charges at the originating end of each call, and would have to pay terminating access to the local service provider terminating the long distance call. However, as more BOCs receive region-wide interLATA authority, the BOC (continued...)

about the three blind men asked to describe an elephant each one of whom gives a picture of only one small part of the animal, a market power analysis that is confined solely to the interstate side of these service bundles would fail to capture the entire picture and, as a result, would reach an erroneous conclusion as to the BOCs' ability to squeeze non-affiliated rivals out of the long distance market.

49. The BOCs themselves have admitted that their presence in the long distance market has changed the competitive landscape to one heavily favoring incumbent local carriers. In its June 6, 2003 Answer to the May 8, 2003 *Petition* filed by AT&T with the Virginia State Corporation Commission seeking reductions in Verizon's intrastate access charges,[64] Verizon retorted that:

> IXCs, including AT&T, however, ***can and do*** compete with the "free long distance" plans of wireless providers and Verizon Long Distance's calling plans under the current access regime. For example, through its "The Neighborhood" package, MCI is competing in today's market. Introduced in Virginia many months prior to Verizon's entry into the long distance market, "The Neighborhood Complete" plan offers unlimited local, long distance, and local toll calls, plus call waiting, caller ID, speed dial, personal voice mail, and 3-way calling for only $49.99 per month. Similarly, Cavalier has announced its "Unlimited Basic Package," which at a price of $49.95 provides unlimited long distance, unlimited local calling, caller ID, voice mail, 900 toll block, call-waiting or talking call waiting, 3-way calling, speed dial, *69, Anonymous Call Rejection, Call-Forwarding, Remote Call-Forwarding, *66, 900 Toll Block, Call Block, and local

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63. (...continued)
is increasingly likely to be the originating *as well as* the terminating local service provider, and as such would merely impute access charges for both ends of the call.

64. *AT&T Communications of Virginia, LLC, v. Verizon Virginia Inc., et al*, Virginia State Corporation Commission Case No. PUC-2003-00091, filed May 8, 2003.

> number portability. Likewise, Sprint has its own bundled package offering in Virginia; the "Sprint Complete Sense Unlimited" plan offers consumers unlimited local calling, unlimited local toll, unlimited domestic long distance, Call waiting, Caller ID, 3-way calling, Speed Calling, Enhanced Voice Mail, Find Me Call Forwarding, Notify Me, and Sprint FONCARD for $54.99.[65]

In advancing this argument, Verizon conveniently neglects to point out that in order for IXCs to provide such "bundles" of their own, *they must themselves also be CLECs* offering local exchange service within the same jurisdiction and to the same base of subscribers that are being served by the dominant ILEC, Verizon in this instance. *Yet that is precisely the point.* By Verizon's own admission, only IXCs that bundle local and long distance services together into the same service package can compete with its "free" long distance calling plans. *Nowhere in Verizon's Answer does the BOC suggest that an IXC providing long distance service on a stand-alone basis can compete with Verizon's Veriations[SM] packages.* In so responding, Verizon has articulated precisely the inextricable linkage between the local exchange services being provided by dominant BOCs and the long distance services being offered by the affiliates of those dominant BOCs, a linkage that *requires* that the BOC long distance affiliates themselves be classified *and regulated* as dominant carriers.

65. *Id.*, Verizon's Motion to Dismiss, Answer, and Affirmative Defenses of the Defendants, June 6, 2003, at 5-6.

Prior to the breakup of the former Bell System, BOCs had the ability to extend their local monopoly into the long distance market, and unless constrained by dominant carrier regulation, that same concern has now reemerged as a result of BOC long distance reentry.

50. The instant consideration of regulating monopoly local carriers providing local and long distance services on a combined basis must be made in the context of the history and background that gave rise to the BOCs' reentry into the long distance business, as contemplated in the 1996 federal legislation. That history begins with the U.S. Department of Justice's ("DOJ") 1974 antitrust case against the pre-divestiture Bell System[66] in which the DOJ alleged, *inter alia*, that the Bell companies were using their local service monopoly to prevent competition in the adjacent long distance market. The *Modification of Final Judgment* ("MFJ"), the 1982 Consent Decree under which the former Bell System was broken up and the Bell Operating Companies were divested from AT&T,[67] prohibited the divested BOCs from offering interLATA long distance services. This remedy was adopted specifically to prevent the BOC local service monopolies from using their monopoly market power in the local services market to block competition in the adjacent long distance market. And because the BOCs were themselves precluded from providing long distance services, they were made to be *indifferent* as to which long distance carrier their customers might individually select. Section 271 of the 1996 Act replaced the MFJ long distance "line of business" restriction with a process by which BOCs

66. *United States v. Western Electric Company, Inc., et al*, Civil Action No. 74-1698 (D.D.C.).

67. *U.S. v. Western Electric Co. et al.*, 552 F. Supp. 131 (D. D.C., 1982), *aff'd sub nom. Maryland vs. U.S.*, 460 U.S. 1007 (1983); and *Modification of Final Judgment*, sec. VIII.B.

could enter the "in-region" long distance market, provided that they implemented a series of specific measures that, in principle, would have the effect of irreversibly opening their previously monopolized local telecommunications markets to competitive entry.[68] The notion here was that, to the extent that the *local* market itself becomes competitive, the BOCs' ability to exert market power in the adjacent long distance market could be attenuated. Conversely, when a BOC is allowed to offer in-region long distance service in a less-than-fully-competitive local market, then the BOC acquires both the ability and the incentive to engage in precisely the same type of anticompetitive conduct that the *MFJ* was intended to prevent.

51. The specific focus, at that time, was on the matter of *access* by competing long distance carriers to originate and terminate calls on the BOCs' *local* networks. Prior to the break-up, the Bell System local companies provided their long distance affiliate with a far superior quality of access to their local networks and customers than was being offered to the nonaffiliated "Other Common Carriers" ("OCCs").[69] For example, calls placed by BOC customers were in all cases automatically routed to their long distance affiliate whenever the customer dialed a call on a "1+" basis; OCC customers were forced to dial lengthy "access codes" and manually enter their billing account information. Additionally, the interconnection arrangements being provided by the BOCs to their long distance affiliate were far superior in a number of other qualitative respects; for example, BOC local and long distance billing was handled on an entirely integrated

68. *See*, *e.g., Bell Atlantic New York Order*, 15 FCC Rcd 3953, 4164.

69. The term "Other Common Carriers" ("OCCs") was used to refer to interexchange carriers other than AT&T.

basis, and the BOC billing system was provided with "answer supervision" by the terminating carrier indicating when the called party answered the call as well as when the called party terminated the conversation by hanging up the phone. The BOC-affiliated long distance carrier was thus able to provide accurate long distance billing to its customers, whereas OCCs, whose interconnection arrangements with the BOCs typically did not include "answer supervision," would often bill for calls that were not answered or fail to bill for short calls that were. BOC reentry into the in-region *interLATA* long distance market has created precisely the same incentive and capability for the BOCs to pursue the very same kind of discrimination, anticompetitive conduct, and unfair market advantage as had prevailed at the time the MFJ was entered. Unless such conduct is constrained by regulation of the BOCs as dominant long distance carriers, the enormous competitive gains and long distance price decreases achieved over the past two decades would soon be reversed.

The BOCs' ability to grow long distance market share at unprecedented rates is a direct result of their unique ability to leverage their local market power through "joint marketing" of local and long distance services.

52. I have previously noted the unprecedented in-region market shares gained by the BOCs in their first few years of interLATA service. The BOCs' ability to grow long distance market share is a direct result of their ability to engage in "joint marketing" of long distance service to its *local* customers. Presumably, the principle/theory driving the FCC's and Congress' acquiescence in such "joint marketing" is that *if the local market is competitive* and as such if customers are given real choices as to whom they contact for local service (which is the

presumption once the "Competitive Checklist" has been satisfied), the RBOC then no longer enjoys any advantage vis-a-vis CLECs with respect to selling customers long distance service either, because CLECs are also free to sell long distance service to *their* local service customers. The principle/theory breaks down, of course, if the local market is not actually competitive, i.e., if customers have no choice but to contact the BOC for local service and if the BOC retains the right to preemptively market long distance service to those customers, then other long distance providers will be blocked from addressing these customers. Put another way, the larger the BOC's share of the *local* market, the greater will be its opportunity to preemptively market its affiliate's long distance service. And if customers exhibit a disproportionate propensity to select the BOC as their long distance carrier as a result of this "first to get there" opportunity, then over time the BOC's long distance market share would also be expected to grow *directly and specifically as a consequence of its ability to preempt competing long distance carriers in signing up new customers*.

53. The economic value of this preemption advantage being enjoyed uniquely by BOC affiliates acquiring interLATA customers is graphically illustrated when one considers the speed and ability of OCCs to gain interLATA market share without similar preemptive advantages. The transition to interLATA equal access began in 1985 and was substantially complete by the end of 1988. The 1985 beginning of the transition to equal access can be thought of as the date at which the elimination of economic barriers to interLATA long distance entry began. That event is then analogous to the BOCs' initial satisfaction of the 14-point checklist which, presumably, eliminated the economic barriers to entry into the local market. But the conse-

quences of these otherwise comparable policy initiatives have been dramatically different: By the end of the fifth year (i.e., by the end of 1990) following the commencement of interLATA equal access, all of the non-AT&T IXCs *combined* had collectively acquired 22.92% of presubscribed lines nationwide,[70] even with the aid of such "jump-start" market development measures as "equal access balloting" and automatic assignment of nonresponding subscribers to a non-AT&T carrier. Of course, what the OCCs did not have then, but which the BOCs do have now, is the massive legacy customer base to exploit. It is thus not surprising that in just two years following its entry into the New York interLATA market, Verizon was able to capture 34.2% of its New York in-franchise local service customers, a level of market share that *no single OCC has ever reached*[71] and that took *all of the OCCs combined* some 10 years (following the 1985 commencement of equal access) to accomplish.[72]

54. In view of the strong parallels between OCC entry in the 1980s and BOC entry today, I believe that the *results* of the earlier policy paradigm offer a useful and reasonable standard against which the current policy initiatives relative to BOC entry can be evaluated. That is, but

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70. Federal Communications Commission, Wireline Competition Bureau, Industry Analysis Division, *Long Distance Market Shares, Fourth Quarter 1998*, March, 1999, ("*Long Distance Market Share Report*"), Table 2.1.

71. According to the most recent (2001) FCC IXC market share report, the largest non-AT&T IXC, MCI Worldcom, had a year-end 1999 residential market share of 16%, well below Verizon's two-year New York share of 34.2%. FCC Industry Analysis and Technology Division, *Statistics of the Long Distance Telephone Industry*, January 2001 (Data as of 1999), Table 24.

72. *Long Distance Market Share Report*, at Table 2.2.

for the BOCs' ability to exploit their inbound marketing channel and offer pricing plans ignoring the cost of access, there is no *a priori* reason to expect their rate of market share growth to differ materially from that of the OCCs in the initial years following "equal access." Conversely, evidence of substantially greater BOC long distance market share growth serves to confirm the enormous value that Verizon and other BOCs obtain solely by virtue of their status as dominant local exchange carriers.

55. The extraordinary marketing advantage uniquely available to BOCs stemming from their market power in the local market and therefore their ability to use the "inbound channel" has not been overlooked by Wall Street. As a February 8, 2001 Credit Suisse First Boston ("CSFB") report commented:

> We've been watching this industry for almost 20 years and we have never seen consumer share gained at the rate of VZ in NY and SBC in TX (the former 20% share in 12 mos and the latter 18% share in 6 months).[73]

When a BOC obtains Section 271 authority, and certainly after Section 272 is allowed to sunset for that carrier in the affected state, it gets not simply the right to enter yet another isolated line of business, but the right to *integrate* local and long distance service into a single package, to make the two services essentially indistinguishable from the consumer's perspective, and to

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73. "VZ: Analyst Mtg Provides Comprehensive `01 Outlook," Credit Suisse First Boston, 09:47am EST, 8-Feb-01 ("*Credit Suisse First Boston Report*").

leverage its dominance of the local market to similarly come to dominate the long distance market as well.

56. It is abundantly apparent that the *entire foundation* of the BOCs' long distance entry strategy rests upon their ability to exploit their local market power, pricing advantages with respect to access and "joint" services, and their legacy relationships with existing BOC local service customers. *De facto*, and ultimately *de jure*, integration of the BOC local and long distance services regardless of the requirements of Section 272 or any other Commission safe-guard, is a critical element of this strategy. Lest there be any doubt about this, the Commission should recall that although BOCs have been permitted into the *out-of-region* long distance market since the enactment of the 1996 *Act* (i.e., February 8, 1996), *none of the RBOCs* (with the exception of Qwest, which was already providing "out-of-region" long distance prior to its merger with US West) *availed themselves of this opportunity* except with respect to certain out-of-region services, such as Calling Card services, that could be marketed to their *in-region* local service customers. Moreover, rather than compete out-of-region, both SBC and Bell Atlantic chose instead to *acquire* via merger out-of-region BOCs, expressly foregoing their opportunity for *immediate* long distance entry in those states but without the opportunity to leverage the ILEC subscriber base, for eventual long distance entry following Section 271 approval when they could pursue the fully integrated joint marketing strategy.

57. That SBC's marketing plans with respect to its long distance service are intimately linked to its legacy local service customer base is further confirmed by the fact that SBC's policy

in its Section 271 states is to limit the availability of SBC long distance service to SBC local service customers only,[74] i.e., to not even offer or provide long distance service to customers of other ILECs or of CLECs where they do not already have a significant cost advantage. Thus, not only has SBC maintained its policy of not pursuing any out-of-region long distance entry, it does not even offer long distance service either to CLEC customers or to Non-SBC ILEC customers *within the states in which SBC has received Section 271 authority*. Such revealed conduct compels the inescapable conclusion that the opportunity to engage in these practices appears to be the sole driver of SBC's interest in the long distance business. Credit Suisse First Boston makes the point profoundly clear in its comparison of (pre-merger) GTE's approach to selling long distance services through a separate CLEC affiliate vs. Verizon's and SBC's ability to offer long distance services directly to their ILEC customers:

> In stark contrast to Verizon's huge and quick 20% consumer LD share gains in NY State, LD subscribership was flat in the GTE franchise areas in '00 despite GTE's benefitting from similar pre-established branding and billing relationships. The difference is that GTE has not leveraged the inbound channel and also had been running its LD effort through its "CLEC", in effect forcing customers to switch to the GTE CLEC both their local service from GTE's ILEC and their LD service from another LD customer. Not very successful if you ask us and certainly worthy of change given the empirical evidence that VZ's and SBC's use

74. SBC's long distance package offers on its website contain the note, "SBC Long Distance provides direct-dialed service in the SBC local service areas where FCC approval has been given. Requires subscription to SBC local service." *See, e.g.* http://www02.sbc.com/Products_Services/Residential/ProdInfo_1/1,,1094--1-3-13,00.html (Accessed June 27, 2003).

of the inbound channel and separate LD sub (but not bundled with local) have been extraordinarily successful.[75]

75. *Credit Suisse First Boston Report*.

REPLACEMENT NEEDED FOR SECTION 272 SAFEGUARDS

The Commission's reliance in the *LEC Classification Order* upon the separate affiliate requirements of Section 272 for forestalling anticompetitive conduct by the BOCs during the first three years of service was misplaced, because in practice these requirements have failed to protect competitors from BOC anticompetitive conduct.

58. As a threshold matter, the FCC, on numerous occasions, has found that BOCs have the ability to "leverage their market power in the local exchange and exchange access markets through cost-misallocation, raising their rivals' costs, improper discrimination to gain an advantage in the interexchange telecommunications services market, or a predatory price squeeze."[76] Initially, during the first three years of BOC long distance provision, the FCC determined that the Congressionally mandated requirements of Section 272 would provide sufficient check on these abilities, and therefore declined to regulate the BOCs as dominant in their provision of interstate, interLATA services.[77] Section 272 required structural separation of the BOC and long distance entities for the first three (3) years following a BOC's receipt of Section 271 authority in a particular state.[78] Interactions between the structurally separated BOC and long distance entities with respect to the use or provision of common or shared resources must conform to a set

76. *FNPRM*, at para. 29.

77. *LEC Classification Order,* at para. 134.

78. 47 U.S.C. § 272(b). The FCC has specifically characterized these requirements as "structural separation" in *Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended*, CC Docket No. 96-149, First Report and Order and Further Notice of Proposed Rulemaking, 11 FCC Rcd 21905 (1996) ("*Non-Accounting Safeguards Order*"), Rcd 21914.

of five conduct provisions set out at Section 272(b) and nondiscrimination requirements set out at Sections 272(c) and 272(e). These structural and transactional safeguards require that the BOC and its long distance affiliate: operate independently from the Bell operating company; maintain separate books, records, and accounts in the manner prescribed by the Commission; have separate officers, directors, and employees from the Bell operating company of which it is an affiliate; not obtain credit under any arrangement that would permit a creditor, upon default, to have recourse to the assets of the Bell operating company; and conduct all transactions with the Bell operating company of which it is an affiliate on an arm's length basis with any such transactions reduced to writing and available for public inspection. In addition, Section 272 requires that the BOC not discriminate between that company or affiliate, and that it impute an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service. These last two requirements survive the sunset of Section 272.

59. The requirements listed above were the Commission's chosen solution to the potential for anticompetitive conduct stemming from BOC market power:

> In light of the requirements established by, and pursuant to, sections 271 and 272, together with other existing Commission rules, we conclude that the BOCs will not be able to use, or leverage, their market power in the local exchange or exchange access markets to such an extent that their section 272 interLATA affiliates could profitably raise and sustain prices of in-region, interstate,

> domestic, interLATA services significantly above competitive levels by restricting the affiliate's own output.[79]

This linkage between "sections 271 and 272, together with other existing Commission rules" and the BOCs' ability "to use, or leverage, their market power in the local exchange or exchange access markets" is no less valid today and for the foreseeable future than it was in 1997 when this determination was made. Put differently, were the Commission to permit the BOCs to operate as non-dominant, there is little doubt that the BOCs *would* "be able to use, or leverage, their market power in the local exchange or exchange access markets" to discriminate against competitive long distance providers and remonopolize the provision of long distance services.

60. The purpose of the Section 272(a) separate affiliate requirement, the Section 272(b) safeguards, the audit requirement of Section 272(d), and the Section 272(c) and 272(e) non-discrimination requirements was, and in many states continues to be, to forestall the potential for discriminatory and anticompetitive conduct arising out of the ability, as an *economic* matter, of the BOC to extend its market power in the *local* telecommunications market into the adjacent long distance market.[80] The Commission, prior to BOC long distance authority and the actual implementation of Section 272, noted that Section 272 contains all of the necessary elements to

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79. *Non-Accounting Safeguards Order*, 11 FCC Rcd 21905, 15763.

80. *Conference Report on S. 652, Telecommunications Act of 1996* (House of Representatives- February 01,1996), *Congressional Record*, H1171.

constrain BOC exercise of this market power.[81] Despite this prediction, however, empirical evidence from states with Section 271 approval and subject to Section 272 requirements indicates that, as currently applied, Section 272 is not by itself sufficient to prevent discrimination and anticompetitive behavior by the BOC for the benefit of its long distance affiliate. The Commission's prior reliance on Section 272 to prevent this behavior was thus misplaced.

The BOCs' revealed implementation of the Section 272 requirements did not constrain their ability to use their local market power to discriminate against interLATA competitors.

61. Based upon the various Verizon and SBC Section 272(b)(5) affiliate transaction postings and service offers provided on the companies' websites[82] and the first Verizon Section 272 Audit report for New York and SBC Texas Audit,[83] it is apparent that the various interactions between the BOCs and their respective 272 long distance affiliates raise serious questions as to the actual, *de facto* extent of "separation" that prevails in practice as between the

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81. *LEC Classification Order*, 12 FCC Rcd 15756, 15763.

82. http://www.verizonld.com/regnotices/index.cfm?OrgID=1; http://www.sbc.com/public_affairs/regulatory_documents/affiliate_agreements/0,5931,199,00.html

83. *In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, Reports of Independent Accountants on Applying Agreed-Upon Procedures, prepared by Pricewaterhouse-Coopers LLP, filed June 11, 2001 and June 18, 2001. ("*New York 272 Audit Report*"); *In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, Reports of Independent Accountants on Applying Agreed-Upon Procedures, prepared by Ernst & Young, filed September 16, 2002. ("*Texas 272 Audit Report*")

two supposedly separate corporate units, and therefore the effectiveness of the *current* 272 separations requirements. The BOC and its affiliate's ability to ignore, for all practical purposes, Section 272, negates what would otherwise be effective competitive safeguards.

62. The importance of maintaining *and effectively enforcing* the separation requirements of Section 272 cannot be overemphasized. Economic theory suggests that, above such regulatory constraints, BOCs have a powerful self-interest incentive to make the structural separation called for at Section 272 as transparent as possible. In fact, this point was made, albeit for a different purpose, in a recent study commissioned by Qwest in support of its various Section 271 applications.[84] The authors explain that

> Double marginalization occurs when two companies have a vertical supplier-customer relationship. The upstream company sets its price, and thus its margin between price and marginal cost, to maximize its own profits. The downstream company likewise sets its price and margin to maximize its profit, treating what it pays the upstream company as cost. If the upstream company begins to offer the downstream product also, it generally will set the final price of the downstream product to maximize its profits jointly from both the upstream and downstream products. The company offering the combined product will often find that it can increase its profits by lowering the price of the final product below price that

84. Jerry A. Hausman, Gregory K. Leonard and J. Gregory Sidak, "The Consumer-Welfare Benefits from Bell Company Entry into Long-Distance Telecommunications: Empirical Evidence from New York and Texas" ("Hausman/Leonard/Sidak" or "HLS"), 70 Antitrust L.J. 463 (2002). Although the authors do not cite the source of their funding in the paper, evidence adduced in the current Section 271 proceeding in Minnesota has identified Qwest as that source. *In the Matter of a Commission Investigation into Qwest's Compliance with Section 271(d)(3)(c)) of the Telecommunications Act of 1996 that the Requested Authorization is Consistent with the Public Interest Convenience and Necessity*, Before the Minnesota Public Utility Commission, PUC Docket No. P-421/CI-01-1373, Qwest response to DOC Information Request 18059.

> would be set in the previous situation. The company offering the combined product will take into account how a lower price on the final product will increase the sale of and profits from the upstream product, while a company offering only the final product will not.

Section 272(b)(5), in requiring that the BOC and its Section 272 affiliate deal with each other "at arm's length," represents an attempt to force the affiliate (the provider of the downstream product) to set its retail prices so as to maximize its own profits, just as any non-affiliated IXC, which is *only* operating in the (same) downstream product market, would be expected to do. But in fact, the BOCs, which supply the upstream (access) service, and their Section 272 affiliates, which supply the downstream (retail long distance) service, are setting their prices to maximize joint profits, as if Section 272 did not exist at all. SBC, BellSouth and Qwest each allow their Section 272 affiliates to cannibalize their BOCs' own customers, using their BOCs' own employees to do so, to migrate customers and revenue from the BOC to the affiliate for intra-LATA toll services. Verizon's Section 272 affiliate expressly conditions the availability of its unlimited interLATA long distance pricing plan on the condition that the customer also purchase a premium and highly profitable bundle of local and intraLATA services from the BOC. *These practices are clearly not consistent with arm's length conduct*, but they certainly do contribute to the corporate "bottom line" while squeezing out non-integrated downstream competitors. As the Qwest consultants observe:

> Although the analysis of double marginalization originally was derived for the case of monopoly, it also applies to imperfect competition, which characterizes telecommunications markets because of the large fixed and common costs. The Areeda-Hovenkamp antitrust treatise, for example, observes that "[t]he double marginalization model appears to make robust predictions that vertical integration

> results in increased output and lower prices any time the affected markets are something less than perfectly competitive." Under current regulatory policies, access and long-distance services are both sold at prices exceeding marginal (incremental) cost, so as to cover the large fixed costs of local and long-distance networks. Although access reform since the Telecommunications Act of 1996 has decreased the BOCs' access margin, it has not eliminated the entire margin. Thus, double marginalization still leads to the prediction that BOC entry into the in-region interLATA market will lead to lower long-distance prices. Our econometric findings are consistent with this economic analysis, which has not been taken into account by the DOJ and FCC in their Section 271 implementation analyses.

But lower long distance prices arising solely or primarily from BOC exploitation of integration efficiencies and joint profit maximization before the local market becomes fully competitive is clearly *not* what Congress had in mind, because if it were then Section 272 would not only have had no purpose, it actually would have interfered with that result. Congress expected *widescale* local competition to develop, and in that way the local/long distance integration efficiencies would have been available to BOCs and to entrants alike. But that did not happen. BOCs still control bottleneck upstream access services and still overwhelmingly dominate the local exchange market. If the BOCs are the *only* downstream providers that are permitted to benefit from these types of integration efficiencies, then they will ultimately be the only downstream providers to survive in the retail long distance mass market. And that outcome is clearly *not* what Congress intended, and will surely result in less competition and higher prices overall.

63. As AT&T has explained in its filings in response to the New York and Texas Audit proceedings, both Verizon and SBC systematically favor their affiliates in the provision of

special access facilities and timely resolution of trouble tickets.[85] Dr. Bell notes, "the limited data provided in the audits reveal that the differences in performance results are statistically significant."[86]

64. The BOCs have effectively removed all pricing requirements from their implementation of Section 272. Section 272(b)(5), as interpreted by the Commission, requires BOCs to price affiliate transactions according to the Commission rules codified at 47 CFR § 32.27. These affiliate transaction rules require the BOCs to price transactions between affiliates at the higher of fully distributed cost or fair market value. In the case where the BOC sells more than 25% of the service to a non-affiliate, the price charged by the BOC is presumptively the "fair market value," and therefore this "prevailing company price" is deemed an appropriate price for the affiliate transaction. In the case of Section 272 affiliates, however, the FCC determined that, since the BOCs are required to make all services provided to their Section 272 affiliates "generally available," BOCs may designate prices for services where less than 25% of the service is provided to non-affiliates as "prevailing company price."[87]

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85. *In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, Declaration of Dr. Robert Bell on Behalf of AT&T, filed January 29, 2003; *In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, Declaration of Dr. Robert Bell on Behalf of AT&T, filed April 8, 2002.

86. *Id.* at para. 7.

87. *Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-
(continued...)

65. The effect of the BOCs' implementation of the Commission's affiliates pricing rules has been for the BOCs to price services to affiliates at any price they wish. Clearly, by applying the affiliate pricing rules it applies generally to Section 272 affiliates in particular, the Commission intended to prevent cost shifting to the BOC. However, unlike most affiliate transactions, transactions between Section 272 affiliates and BOCs are required by statute to be made available to competitors so as to limit the BOCs ability to discriminate in favor of their long distance affiliate. However, instead of making services "generally available" to affiliates and competitors alike, and thus assuring that the prices charged to affiliates do not allow for cost shifting, the BOCs are tailoring their affiliate contracts so as to assure that their affiliates are the only eligible buyers.

66. Consider, for example, the matter of the SBC and Verizon billing and collection services that are furnished by the BOC to the 272 affiliate. Where the 272 affiliate's customer is also a BOC local service customer (as I have noted, SBC's 272 long distance affiliate, SBCS, in fact, will *only* provide service to customers of the local SBC operating company[88]), the incremental cost to the consolidated enterprise of including a customer's long distance billing on the local service bill — which will need to be prepared and mailed, and the payment received and

87. (...continued)
150, *Report and Order*, at para. 137, 11 FCC Rcd 17539, 17601 ("*Accounting Safeguards Order*").

88. The SBC website indicates that "SBC Long Distance provides long distance where arrangements exist with local providers in the SBC Southwestern Bell Telephone Company service area. Queries to the cite indicate that this service is not available to CLEC customers. http:/www.SWBell.com/Products_Services/Residential/ProdInfo_1/1,1973,187–6-3-15,00.html

processed, whether or not the customer subscribes to the affiliate's long distance service — is extremely small. No additional envelope or postage will be required,[89] and the costs of receiving and processing a payment will be entirely unaffected whether or not the payment includes the long distance charges.

67. Billing and collection, however, is classified as a "competitive" service, and as such the BOC has the legal authority and the economic incentive to price the service at whatever the market will bear. In offering this service to competing IXCs, this is precisely the BOCs' practice, and both SBC and Verizon offer billing services to IXCs for an average of over $1 per bill. However, in structuring their pricing of billing and collection services, both Verizon and SBC have also included a "volume discount pricing plan" that reduces the billing charge by an additional $0.10 per bill for Verizon and *over $0.70 per bill for SBC* provided that the billing and collection client agrees to commit 85% of its in-region billing to the BOC– regardless of the actual quantity of individual bills this represents. For example, if an IXC with a total of 10,000 customers commits to use the BOC billing service for at least 8,500 of them, it will be offered the discount; however, if another IXC with one million customers commits to use the BOC billing service for only 500,000 of them, it will not be offered the discount. Obviously, "cost" is not the issue here, in that the discount plan is wholly unrelated to any "volume" commitment made by the IXC. As a practical matter, of course, these "volume discounts" amount to a

89. In most cases, only one or two additional pages of billing will need to be produced, and can be included in the same envelope with no additional postage.

contrived device for discriminating in favor of the BOCs' affiliates vis-a-vis other IXCs, since only the BOCs' affiliates are likely to agree to the 85% "commitment" level.

68. Verizon and SBC also improperly price joint marketing services using Fully Distributed Cost methodologies instead of Fair Market Value. Since the BOCs are not required to provide joint marketing services to competing IXCs, they are unable to simply set a price and designate that price the prevailing market rate. Instead, both Verizon and SBC have ensured that the amount that their long distance affiliates pay the BOCs for joint marketing is significantly below any price that would satisfy the Commission's affiliate pricing requirements. The Commission explicitly requires that BOCs price all services provided to their Section 272 Affiliate that are not subject to tariff or Prevailing Company Pricing, at the higher of fair market value or fully distributed cost. Should the service not be available on the open market, this Commission requires that the BOC *estimate* a fair market value.[90] Yet instead of the conducting the required study and estimating the inbound channel's value, Verizon presented the Section 272 Auditors with a letter stating simply that "FMV could not be obtained for these services."[91] Moreover, Verizon failed to explain why it did not obtain an *estimate* of the fair market value for these

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90. In its *Accounting Safeguards Order*, at 17610, the Commission sets forth "the baseline for a good faith determination of fair market value by requiring carriers to use methods that are routinely used by the general business community." The Commission anticipated that some services would be unique and found, "[w]hen situations arise involving transactions that are not easily valued by independent means, we require carriers to maintain records sufficient to support their value determination." Finally, the Commission notes, "nothing discussed here exempts carriers from their statutory obligation under section 220(c)) to justify their accounting entries."

91. *New York 272 Audit Report*, Appendix A at 21.

services. In the same manner, SBC claims that the fully distributed cost of joint marketing services is higher than the estimated fair market value (an assertion both unsupported by documentation in the Audit and which strains credulity). In California, SBC does not even charge its affiliate fully distributed cost, repeatedly indicating that a "true-up" would be made based upon the results of a time and motion study. According to the SBC Texas Audit, *that true-up had still not been made as of December 11, 2001, well over a year after the time and motion study was completed in August 2000.*[92] Significantly, perhaps the single most important element of the BOC-provided "joint marketing" services is the customer contact itself — the fact that a customer is contacting the BOC to order *local service* thereby providing the BOC with the unique opportunity to preemptively sell the affiliate's long distance service to that inbound caller. The BOCs' overwhelming share of the residential and small business market creates an overwhelming predisposition on the part of most consumers to initiate a contact with the BOC when ordering new local phone service. Indeed, that propensity is reinforced by a publication distributed by the United States Postal Service to customers filing a Change of Address notice that specifically recommends calling one of the BOCs for local telephone service (see Attachment 4). These inbound contacts are extremely valuable to the BOCs' long distance affiliates, enabling them to avoid the kind of massive spending on advertising and other promotional activities that other IXCs regularly confront. *All of the 'time and motion studies" in the world cannot possibly come even close to capturing this enormous value*, a value that is entirely *ignored* by the BOCs in pricing their "joint marketing" services to their long distance affiliates.

92. *Texas 272 Audit Report*, Attachment B-2, at 6 and Attachment B-1 at 3.

69. In providing services to their Section 272 affiliates, the BOCs thus ignore the explicit "arm's length transaction" prescription of Section 272(b)(5). Entities engaging in arm's length transactions are expected each to pursue their own self-interests. The entity providing the services is expected to impose the highest price that the buyer is willing to pay, and to limit the extent of any services provided to those that do not undermine the providing entity's own business interests. Certainly that is how BOCs generally conduct themselves in transacting business with CLECs and nonaffiliated IXCs. But when it comes to dealing with their affiliates, the "arms" seem to look a lot more like a hug.

70. A case in point is the BOC entity's conduct with respect to the marketing of *intraLATA* toll services, where the BOC competes directly with its Section 272 affiliate. Ordinarily, one would not expect a firm providing marketing services "at arm's length" to another firm to voluntarily seek to induce *its own customers* to discontinue use of that firm's services in favor of competing services that are offered by its client. Yet that is precisely what occurs every day when a BOC "markets" its affiliate's long distance services. The SBC, BellSouth and Qwest Section 272 affiliates all offer "unlimited" long distance calling plans that include both intraLATA and interLATA calling, and as such *require* that the customer select the affiliate as his intraLATA PIC. This cannibalization of the BOC's customer base transfers earnings out of the regulated BOC entity and over to the nonregulated affiliate, a move that could ultimately erode the BOC's earnings to the point where it would seek rate relief from either the state commission or the FCC. And, of course, nothing in the "price" that the affiliate pays the BOC for delivering

its customers "on a silver platter" remotely reflects the enormous value that this practice confers upon the affiliate.

Additional anticompetitive BOC conduct stems from the BOCs' tying arrangements between their monopoly local and competitive intraLATA service offerings.

71. Even the linkage between local and intraLATA may be blurred and may force a BOC local service customer to select the BOC for the LPIC in order to qualify for bundled local/toll pricing packages. For example, in several of its northeast states, Verizon offers expanded local calling options under which certain routes that would ordinarily be subject to per-call toll charges are incorporated, either on a flat-rate or a measured-rate basis, into the subscriber's (expanded) local calling area. In Massachusetts, Verizon customers in the greater Boston area can elect a calling plan known as "Metropolitan Service" in which certain toll routes are then incorporated within the subscriber's unlimited local calling scope.[93] In other parts of the state, subscribers can order "Circle Calling Service," which effectively converts toll routes within a roughly 20-mile radius to local rate treatment.[94] IntraLATA calls beyond the expanded Metropolitan or Circle Calling service areas continue to be rated as toll. However, if the Verizon customer selects an IXC *other than Verizon* as that customer's intraLATA PIC, *all of the Metropolitan and Circle Calling calls that — but for the calling plan — would have otherwise*

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93. Verizon Massachusetts, DTE MA No. 10, Part A, Section 6, original page 49, effective July 14, 1999.

94. Verizon Massachusetts, DTE MA No. 10, Part A, Section 6, original page 36, effective July 14, 1999.

been rated as toll will be routed to the presubscribed IXC, thereby subjecting such calls to toll charges and in so doing effectively eliminating the benefit of the optional expanded calling arrangement.

72. In New Jersey, a similar situation arises with respect to "Selective Calling Service," an expanded local calling plan in which the subscriber "selects" one or more nearby toll exchanges for block-of-time measured-use pricing,[95] as well as with a special no-charge, non-optional Intra-Municipality Calling ("IMC") service in which toll charges that might otherwise apply between points in different telephone exchanges within the same political subdivision are waived.[96] In May of 1997, concurrently with the implementation of intraLATA 1+ equal access in New Jersey, Verizon's predecessor (Bell Atlantic-New Jersey) sent letters to all of its Selective Calling and Intra-Municipality Calling Service subscribers warning them that if they were to chose an intraLATA IXC *other than Bell Atlantic*, they would lose their Selective Calling and Intra-Municipality Calling Services.[97] Bell Atlantic-New Jersey went even further in its attempt to link its local and intraLATA toll services when, in 1999, it proposed to bundle the first 25 minutes per month of intraLATA toll calling into the basic monthly rate for *local* residential

95. Verizon New Jersey, B.P.U. N.J. No. 2, Section A6, seventh revised page 18, second revised page 19, effective December 6, 1997; first revised page 20, effective September 1, 1999; sixth revised page 21, effective June 18, 2001.

96. Verizon New Jersey, B.P.U. N.J. No. 2, Section A6, second revised page 13.1-13.10, effective September 1, 1999.

97. Bell Atlantic New Jersey Letter, dated May, 1997.

service.[98] As with Selective Calling and Intra-Municipal Calling services, if the customer selected an intraLATA PIC other than Bell Atlantic-New Jersey, the customer would forego that 25 minutes worth of included intraLATA toll, but would realize no reduction in the monthly rate for the diminished service package. This particular local/toll bundling plan was subsequently withdrawn by Bell Atlantic in the face of New Jersey Board of Public Utilities (NJBPU) rejection of its overall Plan for Alternative Regulation ("PAR") proposal,[99] but the fact that such a proposal was introduced in the first place serves to demonstrate how a BOC's dominance of the local market can be leveraged to limit competition for toll services.

73. The potential for a BOC to extend its local service monopoly into the intraLATA toll market is not confined to the intrastate jurisdiction. Many LATAs cross state lines, and embrace *interstate* intraLATA toll routes that are subject to the intraLATA PIC but which are tariffed and rated as interstate toll calls. For example, the entire state of Delaware lies within the Philadelphia LATA. IntraLATA toll calls from points in Delaware to the Pennsylvania portion of the LATA, and vice versa, are rated as interstate, yet are carried by Verizon Delaware or Verizon Pennsylvania, as the case may be, for those customers who have selected the BOC as their intraLATA toll carrier. Verizon Delaware offers certain of its residential subscribers an

98. Application of Bell Atlantic-New Jersey, Inc. for Approval of a Modified Plan for an Alternative Form of Regulation and to Reclassify All Rate Regulated Services as Competitive Services, New Jersey, filed with the New Jersey Board of Public Utilities on December 30, 1999.

99. *In the Matter of Application of Bell Atlantic-New Jersey, Inc. for Approval of a Modified Plan for an Alternative Form of Regulation and to Reclassify All Rate Regulated Services as Competitive Services*, New Jersey BPU Docket No. TO99120934, *Order*, December 22, 2000.

optional extended area calling plan known as the "Two County Calling Plan," in which calls that would otherwise be rated as toll are included within the customer's unlimited local calling scope.[100] If the subscriber selects this plan, he must designate Verizon Delaware as his intra-LATA PIC, which means that interstate calls placed to the Philadelphia portion of the LATA will also be carried by Verizon. Similarly, Verizon Pennsylvania offers customers in certain Philadelphia LATA exchanges a type of selective calling option known as "Residence Calling Plus,"[101] providing unlimited calling to one or two nearby exchanges that would otherwise be rated as intraLATA toll. Here, too, the customer electing this expanded local calling option must designate Verizon Pennsylvania as his intraLATA PIC, which means that Verizon Pennsylvania will also carry that subscriber's other intraLATA toll calls including any interstate calls to Delaware. And, as with the cases of Massachusetts and New Jersey, if the customer designates an IXC as the intraLATA PIC, he will not be able to subscribe to the optional extended calling plan.

100. Verizon Delaware Inc., Tariff P.S.C.-Del. No. 3A, Sixth Revised Sheet 1C, issued and effective October 16, 2000; Twelfth Revised Sheet 4B, issued September 30, 2002, effective October 29, 2002. Significantly, the "Two County Calling Plan" appears in Verizon Delaware's Exchange Service Tariff, not its intrastate Message Telecommunications Service ("MTS") Tariff. However, a notation appearing on Sheet 4B states that "Two County Calling Plan customers are not eligible for Customer-Requested Toll Restriction."

101. Verizon Pennsylvania Inc., Informational Tariff for Competitive Services Pa. PUC No. 500, Original Sheets 7-14, issued September 20, 2001, effective March 15, 2002.

DOMINANT CARRIER REGULATION AND STRENGTHENED PERFORMANCE MEASURES WILL HELP PREVENT BOC ANTICOMPETITIVE BEHAVIOR

Dominant carrier regulation will require the BOCs to provide cost support and usage data so as to permit the Commission to assess a BOCs compliance with imputation, cost allocation, nondiscrimination and affiliate transaction requirements, and in so doing to forestall the BOCs' ability to leverage their local market power into the adjacent and presently competitive long distance market.

74. Evidence of BOC market power and market power abuses indicate that the competitive safeguards of the separate affiliate provisions of Section 272 currently being relied upon by the FCC have failed to prevent anticompetitive conduct. If the purpose of enacting Section 272 was "in order to check potential market power abuses," then it is both necessary and entirely appropriate for the Commission, in this proceeding, to determine whether the BOCs still possess market power and, if they do, that one fact alone provides sufficient basis and justification for enforcing strong requirements designed to preclude *integrated* BOCs from further leveraging their control over bottleneck facilities to gain a competitive advantage over their interLATA competitors. The presence of pervasive market power and market dominance by the BOCs in the residential and small business local services affords BOCs with:

- The unique ability to leverage that local market power so as to diminish competition in and, ultimately, to remonopolize the adjacent residential/small business long distance market;

- The ability and the incentives to discriminate against competing local and long distance carriers with respect to the provision of essential services; and

- The ability and the incentives to price those essential services and their own retail services in such a way as to create a price squeeze, the practical effect of which will be to make effective competition in the retail service market all but impossible.

75. The BOCs' unique ability to engage in joint marketing and to benefit uniquely from their legacy relationships with the vast majority of residential and small business local service customers in their effort at acquiring long distance market share has the potential to lead ultimately to BOC remonopolization of the long distance market, at least at the retail residential and small business level. That potential is exacerbated when the separate affiliate requirement is eliminated, because the BOCs are then in a position to complement their already substantial marketing advantage with the additional ability and opportunity to discriminate against competitors in the provision of access and other essential services and the creation of price squeezes between the BOCs' own retail long distance prices and those being charged to rivals for access to the BOCs' networks. Remonopolization will ultimately lead to higher retail long distance prices, potentially costing consumers billions of dollars nationwide. And we won't have to wait for full remonopolization before those rate increases will be initiated. Whatever the "costs" of stringent regulation of the BOCs' integrated interLATA service provisioning practices, the potential harms to competition and consumers arising from BOC remonopolization of retail long distance services more than justify those "costs" on a strictly cost/benefit basis.

76. Importantly, when the separate affiliate requirement is allowed to sunset and the Section 272(b)(1) "operate independently" and 272(b)(5) "arm's length" requirements are eliminated, BOCs are no longer under any obligation to "sell" access services to their long distance business

units at tariff rates. The sole remaining "safeguard" against discrimination with respect to access services will be Section 272(e)(3), which is not subject to the sunset provision. Section 272(e)(3) requires the BOC to "... impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service." "Imputation" requirements of this type are applied by state commissions in the case of ILEC-provided competitive *intraLATA* toll services, but due to the absence of explicit access charges, precise application of such rules is particularly difficult. ILECs have argued, for example, that they are free to aggregate different services together in demonstrating that the imputation requirement has been satisfied, which may permit certain services to be priced below the imputation level only to be offset (i.e., cross-subsidized) by others whose prices exceed the applicable access charges. Such contentions have been rejected by state commissions,[102] but only after the practice had been underway for some time and following often protracted litigation. Proper application of an imputation requirement such as that contained at Section 272(e)(3) would require the BOC to demonstrate that its retail price exceeds the sum of the imputed access charges together with all costs incident to the value-added (long distance) services of which those access services are a component. Short of protracted complaint proceedings, I am not

102. *See, e.g. Application of Qwest Corporation for an Increase in Revenues,* Oregon Public Utilities Commission, Order no. 01-810, 2001 Ore. PUC LEXIS 449, September 14, 2001, (order unpaginated, at "Access Charge Imputation" section), and *Application of US West Communications, Inc., for the Commission to Open an Investigatory Docket to Eliminate on an Expedited Basis the Requirements that US West Impute Switched Access Rates into the Price Floor of its IntraLATA Long Distance Service*, Colorado Public Utilities Commission, Docket No. 00A-201T, 2001 Colo. PUC LEXIS 133, January 24, 2001, at *16.

aware of any remaining mechanism, especially for an integrated local and long distance BOC, that would permit the Commission or affected competitors to verify compliance with Section 272(e)(3).

77. Regulation of BOC long distance affiliates and integrated long distance business units as dominant carriers will provide the Commission with a mechanism to enforce the Section 272(e)(3) imputation requirement. BOCs will be required to submit additional supporting information with tariff transmittals that are sufficient to demonstrate that their rates fully recover all relevant *non-access* incremental costs and also satisfy access imputation. Specifically, dominant carriers with gross annual revenues exceeding $500,000 for the most recent 12 month period must submit an explanation of the changed or new services and/or rates, the "basis of ratemaking employed, and economic information to support the changed or new matter."[103] This economic information includes a cost of service study for all elements for the most recent 12 month period; a study containing a projection of costs for "a representative 12 month period"; and estimates of the effect of the tariff change upon the traffic and revenues from that service (or the effect of the new tariff), the carrier's other services and the carrier's "overall traffic and revenues."[104] Dominant carriers must also provide the Pricing Policy Division of the Commission with working papers and statistical data supporting the tariff change or filing of new service.[105]

103. 47 CRF §61.38 (b)

104. 47 CFR §61.38 (b)(1)

105. 47 CFR §61.38 (C)

78. The supporting cost data required by dominant carrier regulation is the only viable means for the Commission to verify compliance with the imputation requirements of the Act. As previously noted, the BOCs already offer interLATA pricing plans that likely violate the imputation requirements of Section 272(e). A projection of costs including imputed access and actual non-access costs would enable the Commission to determine whether plans such as the $15 Verizon unlimited interLATA offering create a price squeeze.

Current imputation rules are ineffective in protecting competing IXCs from price squeezes and other anticompetitive conduct on the part of BOCs.

79. In addition to ignoring the Commission's "softer" requirements regarding affiliate transactions, the BOCs are flouting the Section 272(e)(3) requirement that a BOC "shall charge the affiliate described in subsection (a), or impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service."

80. As I have previously discussed, BOCs continue to maintain overwhelming dominance of the local exchange telephone service market, particularly in the residential and small business segment. In order to provide long distance services to most residential and business customers, IXCs *must* purchase switched access services from a BOC or other ILEC. For this reason, intra-state switched access must still be considered and treated for regulatory purposes as a monopoly bottleneck essential service.

81. Because the BOCs continue to serve the vast majority of subscriber lines, in order for an IXC to reach most consumers and businesses for purposes of both originating and terminating toll calls, it must pass through an ILEC "gateway" and pay the ILEC access charges at whatever rate applies. Now that ILECs (especially BOCs) are themselves heavily involved in the long distance business, they have a strong business incentive to keep their intrastate access charges as high as possible so as both to increase rivals' costs and to maintain artificially high retail long distance prices while still setting those prices at or even below the level of the *wholesale* access charges that rival IXCs are forced to pay.

82. In theory, the "imputation" requirement at Section 272(e)(3) is supposed to address and resolve this concern. Imputation is supposed to impose "pricing parity" as between the BOC and its rivals — whatever the BOC charges its competitors, it is supposed to charge — or "impute" — to itself. However, BOCs do not actually pay *themselves* cash out-of-pocket for whatever access services (or their equivalent) they utilize in furnishing long distance services. Such payments by the long distance affiliate — particularly where the BOC entity is subject to "pure" price cap regulation without any earnings sharing or earnings cap requirement — are intra-corporate "paper" transactions that have no effect whatsoever upon the parent corporation's "bottom line." The BOC will never incur any *originating* access charges and, since the vast majority of BOC-originated intrastate toll calls are also terminated to customers of the same BOC, the BOC will be required to make a cash payment for terminating access to a different

LEC for only a very small fraction of all intrastate calls originated by its local service subscribers.[106]

83. The purpose of requiring that a BOC "impute" access charges into the retail prices it sets for its end-user services is to try to force the BOC to treat as "costs" to itself the level of payments that its competitors are required to make to the BOC for access services. Unfortunately, however, since BOCs do not actually incur such "costs" in the form of out-of-pocket cash payments to another entity, the imputation requirement does not interfere with their overall

106. In its 1997 *LEC Classification Order*, the Commission (at para. 129 and based upon a claim made by Ameritech) theorized that "a BOC interLATA affiliate's apparent cost advantage resulting from its avoidance of access charges may be offset by other costs it must incur, such as the cost of interLATA transport, which, at least initially, may be greater than the true marginal cost of interLATA transport for facilities-based interLATA carriers. " Not only is there no evidence to affirmatively support this claim, it is likely to be wrong as a matter of fact. Under the so-called "official services exception" of the *MFJ* (United States v. Western Electric Co., 569 F. Supp. 1057, 1097 *et seq.*), the BOCs were expressly permitted to construct, maintain and utilize interLATA facilities for the purpose of transmitting intracompany (so-called "official") traffic. Over time, the BOCs were authorized to expand the use of these intracompany networks to include, for example, the transmission of calls to directory assistance and operator services to remotely located centralized facilities. The succession of RBOC mergers expanded the geographic scope of these networks to correspond with the now more expansive RBOC operating regions. The costs of these interLATA fiber-optic transmission networks were absorbed by the regulated BOC entities, and much of those capital outlays have by now been recovered in depreciation accruals included in rates for monopoly services charged to BOC ratepayers. If the Section 272 separate affiliate requirement is ultimately permitted to sunset for all BOC Section 271 jurisdictions, these facilities will be available to the BOCs for use in providing long distance service at little or no incremental cost. Thus, rather than somehow "offsetting" the BOCs' access cost advantage, the existence of these extensive interLATA networks affords them a formidable interexchange transport cost advantage as well.

profit incentives, which are to maximize profits relative to actual costs, not artificially contrived "costs" that do not really exist.

84. In fact, an examination of BOC and long distance affiliate conduct demonstrates that any such "imputations" are being ignored altogether when it comes to setting retail long distance prices. Verizon's unlimited long distance calling plan, *Veriations Freedom*^{SM}*,* consists of two separate service components, one of which is furnished by the Verizon BOC entity and the other by VLD. I have previously addressed the serious imputation issues surrounding the VLD inter-LATA plan arising from its aggregation of interstate and intrastate services. The *local* component is usually called "Local Package Basic" or "Local Package Plus" (or a similar name). Filed with the state commissions in the appropriate local tariff, the Local Package Basic and Local Package Plus plans offer basic local exchange dial tone service with unlimited local calling, a selection of vertical "custom calling" features (usually three or four features for Local Package Basic and either a larger number of features, or all features that are available, for Local Package Plus), voice mail, and unlimited intraLATA toll calling (and sometimes unlimited directory assistance calling). All normal nonrecurring charges are typically waived. Prices for these plans typically range from approximately $35 to $55.[107]

85. When intrastate toll services are combined with services other than intrastate toll and priced on a bundled basis, as is the case with the Veriations Freedom^{SM} package, the precise

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107. *See,* para. 40 *supra.*

identification of the "pure" price for the intrastate toll component requires further analysis. A number of the Verizon BOCs have for some time been offering their subscribers a choice of two service bundles that they call something like "Local Package Standard" and "Local Package." These packages include a selection of custom calling features but do not include unlimited intra-LATA calling. Verizon Virginia, for example, offers its Local Package Plus bundle at $32.95 per month, not including Voice Mail, which is offered for an additional $6.50 per month, for a total of $39.45. The Local Package Plus includes a local exchange dial tone line, unlimited local calling, all available custom calling features and unlimited local directory assistance, but does not include the unlimited intraLATA toll feature. By comparison, the monthly rate for the Veriations Freedom℠ Local Package Plus bundle, which includes all of the same features *plus* unlimited intraLATA toll, is $39.95. On that basis, we can identify the effective price for the unlimited intraLATA toll calling feature as the difference between these two prices, i.e., $0.50. This analysis is summarized on the following table, which compares the currently available bundled "Local Package" with the similar Veriations Freedom℠ "Local Package Plus" bundles.

Table 2

Verizon Virginia
Analysis of Effective Monthly Price for Unlimited IntraLATA Toll Calling

Rate element	**Local Package**	**Local Package Plus (Veriations Freedom℠)**
Monthly rate	$32.95	$39.95
Basic local dial tone line	Included	Included
Unlimited local calling	Included	Included
Vertical features	All	All
Unlimited local directory assistance	Included	Included
Voice mail	$6.50	Included
Unlimited intraLATA toll calling	Not included	Included
TOTAL PRICE	$39.45	$39.95
Effective price of unlimited intraLATA calling		**$0.50**

Verizon Virginia Inc. General Services Tariff S.C.C. Va. No. 203, Section 31, 2nd revised page 2-3, effective November 4, 2002; Original page 4-5, effective November 4, 2002; Original page 6-7, effective February 3, 2003.

86. As I have previously noted, Verizon promotional materials put the average “regional toll” (i.e., intraLATA) usage of its Veriations Freedom℠ bundle at 300 minutes per month. Assuming an average intrastate switched access rate (originating + terminating) of 7.5 cents per minute, Verizon would need to “impute” some $22.50 worth of access charges into a service that it offers at retail for just 50 cents! By any standard, Verizon is not coming even remotely close to satisfying any “imputation” requirement with respect to the pricing of this service. Verizon would clearly not offer a service at a price of 50 cents if its actual “cost” were at least $22.50;

the fact that Verizon is doing so despite the access imputation requirement demonstrates that Verizon affords no importance to that imputation requirement in dictating or constraining its pricing conduct. Unfortunately, any competing non-affiliated interexchange carrier offering a comparable flat-rated service and anticipating similar usage characteristics would be required to pay that $22.50 *in cash* to Verizon and other LECs for access services, and so would have no practical means for competing with Verizon's 50 cent retail price.

87. The matter of access imputation is expressly addressed in the 1996 *Act*. As a threshold matter, Section 272(e)(3) requires that

> [a] Bell operating company and an affiliate that is subject to the requirements of section 251(c)) ... shall charge the affiliate described in subsection (a), or impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service.

Although the statute speaks of "imputation" of the BOC's own access charges, it does not specifically require that the price charged at retail for the BOC's or for its affiliate's long distance service actually be set in excess of the imputed access charge. Indeed, Verizon has recently argued that VLD is not subject to *any* imputation requirement with respect to its retail long distance rates.[108] Even if the BOCs were in fact treating "imputed" access charges as

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108. See *AT&T Communications of the Pacific Northwest, Inc., Complainant, vs. Verizon Northwest, Inc., Respondent*, Washington UTC Docket No. UT-020406, Verizon's Motion to Dismiss, April 24, 2002, at 11; Direct Testimony of Orville D. Fulp on behalf of Verizon Northwest, Inc., December 3, 2002, at 10-11.

"costs" when setting their own retail prices, which they obviously are not, the imputation requirement set out at Section 272(e)(3) is not by itself sufficient to prevent the BOC from creating a price squeeze situations for rival IXCs.

88. Access charges are hardly the only "costs" than the BOC or a nonaffiliated IXC would incur in furnishing long distance services to retail customers. Although the precise components of such "non-access" costs have been subject to some dispute,[109] there can be *no dispute whatsoever* that the non-access costs are greater than zero. If Section 272(e)(3) is interpreted as requiring only that the BOC and its Section 272 affiliate set their retail long distance prices *at no less than the "imputed" access charge payments*, the presence of *any* non-access costs would place rival IXCs in a price squeeze if the BOC's retail price fails to cover such non-access costs. From the BOC's perspective, non-access costs include, *inter alia*, sales and marketing, billing and collection, uncollectibles, customer care, and non-access network costs. If the BOC's affiliate is providing retail long distance service by reselling wholesale long distance services acquired from another IXC — as most of the BOCs are actually doing most of the time — then the wholesale rates being paid for the resold services would also constitute non-access costs. Many of the non-access costs associated with BOC long distance services involve services that are furnished by the BOC to its long distance affiliate (or post-sunset of Section 272, to its long distance business unit) on a fully integrated basis. Thus, in addition to assuring that the BOC's

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109. See generally *AT&T Communications of the Pacific Northwest, Inc., Complainant, vs. Verizon Northwest, Inc., Respondent*, Washington UTC Docket No. UT-020406, Direct Testimony of Terry R. Dye on behalf of Verizon Northwest and Direct Testimony of Carl R. Danner on behalf of Verizon Northwest, Inc., December 3, 2002.

long distance prices recover both its imputed access charges *and* all applicable non-access costs, it is also essential that the manner in which the joint costs of functions supporting both the BOC's local and long distance services are allocated as between these two service categories be part of the tariff review process. If the BOC assigns only the incremental portion of the joint cost of local/long distance functions (e.g., sales and marketing, customer service, billing and collection) to the latter category, then it will in effect be conferring 100% of the benefits of integrated operation upon its competitive long distance business. And, for any IXC that attempts to provide long distance service without also providing the customer's local service as well, the BOC's actions will necessarily work to create a price squeeze to the extent that the IXC is required to provide these same support functions on a stand-alone basis.

89. BOCs have also argued that any imputation test should be made in the aggregate, with respect to all categories of interexchange services, not on a service-by-service basis.[110] Under that theory, a particular service could fail imputation so long as another service passed the "imputation test" by an amount sufficient that, taken together, the two in aggregate satisfied the imputation requirement. Thus, the BOC could use profits from intraLATA toll, for example, to cross-subsidize interLATA toll, so long as the two services taken together nominally satisfy imputation. Along the same lines, a BOC could offer a flat-rated toll service[111] that by itself does

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110. *See, Section 272(f)(1) Sunset of the Separate Affiliate and Related Requirements*, WC Docket No. 02-112, Selwyn Declaration on Behalf of AT&T, filed August 5, 2002, ("*Selwyn Sunset Declaration*") at fn. 83.

111. Verizon New England offers its Massachusetts residential customers a flat-rated
(continued...)

not satisfy the imputation requirement, so long as profits from other by-the-call services provide sufficient contribution above access charges so that these two service categories, in aggregate, satisfy imputation.[112] Since imputed access charge "payments" do not actually "cost" the BOC anything above the incremental costs of the access services themselves, imputation rules *per se* are not sufficient to prevent a BOC from engaging in price squeeze tactics.

90. If BOCs are permitted to provide interLATA and local services on a fully integrated basis, they will not use "access services" at all, and will gain enormous competitive advantage over competing interLATA service providers. BOCs might then argue that any imputation requirement should be applied across all interexchange services (intraLATA and interLATA) in aggregate, creating the potential for inter-service cross-subsidization where the extent of actual competition differs from market to market. Additionally, the elimination of the separate affiliate

111. (...continued)
LATA-wide unlimited calling plan as well as optional extended calling plans to provide flat-rate calling to points that would otherwise be subject to toll charges; Verizon New Jersey offers "Selective Calling Service" whereby residential customers can obtain 20 hours of calling to specified ("selected") exchanges for a flat monthly charge.

112. Verizon New Jersey (then Bell Atlantic New Jersey) had advanced just such an argument in response to a Complaint filed by AT&T in 1997, in which AT&T had argued that Bell Atlantic's "Selective Calling Service" did not satisfy the NJBPU's imputation requirement. Selective calling provides block-of-time calling to specific nearby exchanges designated by the customer, for a small monthly charge. Bell Atlantic's position was that as long as all of its intra-LATA toll in aggregate satisfied imputation, there was no requirement that Selective Calling Service by itself be priced in excess of applicable access charges. New Jersey Board of Public Utilities, *In the Matter of Petition of AT&T Communications of New Jersey, Inc. for Determination of Compliance By Bell Atlantic–New Jersey, Inc.'s Selective Calling and Intramunicipal Calling Services with Imputation Requirements*, BPU Docket No. TO97100808, OAL Docket No. PUCOT 11326-97N, Complaint of AT&T and MCI, filed October 1997.

requirement will make it all but impossible to actually track the costs that are being "assigned" to such competitive services, costs that are supposed to be added to the "imputed" access charges to determine whether the imputation requirement has been met.

91. The BOCs' core position here is that they should be permitted to operate their *competitive* businesses (interLATA toll) *incrementally* with respect to their core monopoly local service business. Under this theory, the captive local service customer pays the entire cost of all jointly-used network facilities and organizational resources. We have already seen examples of this philosophy with respect to the attribution of "joint marketing" costs to the 272 affiliate, with only the small increment of time that the service representative spends dealing with long distance service being "charged" to the affiliate.[113] As long as the BOCs maintain near-total monopoly in the local market, competition under such conditions cannot be expected to survive for very long.

92. A nonaffiliated IXC that is required to pay the BOC cash for any access services it utilizes in the provision of the IXC's retail long distance service cannot realistically afford to sell specific services at less than the sum of its access payments in connection with that service and its other, non-access costs of providing it. A service-by-service imputation requirement puts the

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113. Verizon New York charges Verizon Long Distance $7.71 per customer contact, while SBC Telecom charges SBCLD $17.95 in Texas per customer acquisition. *See*, http://www.verizonld.com/PDFs/jmaam40ratesch061603.pdf; http://www.sbc.com/public_affairs/regulatory_documents/affiliate_agreements/SWBTtoSBCLDConsumerSupportSchedule994PA5-22-03.xls (accessed June 30, 2003).

BOC in essentially the same economic condition as its nonaffiliated rivals. The BOC must be made to demonstrate, for each identifiable service offering,[114] that the revenues being derived therefrom exceed the access charges it would have had to pay were it a separate, nonaffiliated entity *plus* the non-access costs it incurs in providing the service. Additionally, notwithstanding the bundling of multiple services (such as local dial tone, vertical features, and long distance) into a single, unified pricing plan, the effective incremental charge for any individual component in the bundle (i.e., the difference between the price of the bundle with the component and the price of the bundle without it) must similarly exceed the sum of imputed access charge (or other underling services being furnished by the BOC) plus the incremental non-access costs.

93. Implementation and enforcement of this requirement can only be assured under full dominant carrier regulation, because it is only through the tariff filing and review process that the relationship between rates and costs, and the manner in which the costs have been determined, can be evaluated. BOCs — Verizon and SBC in particular — are both seeking waivers of the Section 272(b)(1) "operate independently" requirement on the grounds that integrated operation of their local and long distance businesses will produce substantial cost savings due to the numerous cost synergies the BOCs allege to exist as between their local and long distance operations. But the presence of substantial joint costs raises the specter of serious misallocation

114. "Service" in this context refers to a defined pricing arrangement that is being offered to retail customers. There can be some flexibility with respect to individual pricing elements (e.g., time-of-day discounts or "free" off-peak minutes), provided that in aggregate all of the individual element rates, multiplied by the quantities being demanded by all customers selecting the particular pricing plan, are sufficient to cover imputed access and incremental non-access costs.

of those costs, favoring the competitive services to the detriment of the core monopoly services operations. Without dominant carrier regulation and full tariff and cost reviews, there is little practical means even to identify, let alone correct, efforts by the then-integrated BOCs to assign as much of these joint costs to their regulated operations as possible, or to shift joint costs out of competitive services and over to monopoly services so as to support discriminatory pricing of their competitive services.

BOCs have both the means and the incentive to engage in predation, and will have the ability to raise prices once their rivals are forced out of the market.

94. In its 1997 *LEC Classification Order*, the Commission speculated that

> ... even if a BOC were able to allocate improperly the costs of its affiliate's inter-LATA services, we conclude that it is unlikely that a BOC interLATA affiliate could engage successfully in predation. At least four interexchange carriers — AT&T, MCI, Sprint, and LDDS WorldCom — have nationwide, or near-nationwide, network facilities that cover every BOC region. These are large well-established companies with millions of customers throughout the nation. It is unlikely, therefore, that a BOC interLATA affiliate, whose customers are likely to be concentrated in the BOC's local service region, could drive one or more of these national companies from the market. Even if it could do so, it is doubtful that the BOC interLATA affiliate would later be able to raise prices in order to recoup lost revenues. As Professor Spulber has observed, "even in the unlikely event that [a BOC interLATA affiliate] could drive one of the three large inter-exchange carriers into bankruptcy, the fiber-optic transmission capacity of that carrier would remain intact, ready for another firm to buy the capacity at distress sale and immediately undercut the [affiliate's] noncompetitive prices."[115]

115. *LEC Classification Order*, at para. 107, footnotes omitted.

Events since the 1997 release of this *Order* require that these assessments be reexamined. The four IXCs specifically identified by the FCC have since become three, one of which is currently in bankruptcy. BOCs have had unprecedented success in rapidly acquiring long distance market share — particularly in the residential/small business sector. As I previously noted, SBC has reported a 60% share of the Connecticut long distance market after approximately five years since SNET began actively marketing interLATA services, and has advised investors that a similar end-state share can be expected for each of SBC's other Section 271 jurisdictions.[116]

95. Finally, the speculation advanced by Professor Spulber, which the Commission had at that time accepted, is also belied by subsequent developments. While it is true that there is substantial interexchange network, the interexchange transport component of end-to-end long distance service is at this point a relatively minor cost element and its subsequent reacquisition and reuse by another carrier (following the bankruptcy of one or more of the existing entities) is neither assured nor particularly germane to the future of a competitive marketplace. The primary cost elements of retail long distance service consist of access charge payments to ILECs, billing and collection, advertising and marketing, and customer service, all of which dwarf the minuscule costs associated with interexchange transport. Even if a start-up long distance carrier were to obtain an in-place interexchange network essentially for free, its savings on network-related transport costs would be far less than the savings that a BOC is able to realize from not having to pay itself originating access charges and the various other integration efficiencies that

116. SBC Investor Briefing analyst conference call, January 28, 2003.

are available only to the BOC. Indeed, because interexchange transport capacity is not a factor in limiting the supply of retail long distance service, it is extremely unlikely that any such capacity that might be released by a departing carrier would remain in use.

96. BOC bundled local/long distance pricing plans in which the price of the long distance component does not cover the sum of imputed access charges plus incremental non-access costs, together with the excessive access charge price levels that BOCs and other ILECs are permitted to apply, results in a price squeeze that has the potential to force stand-alone IXCs out of the market. Were that to occur, the departing carriers' existing service infrastructures — sales and marketing forces, customer service personnel, operations support systems, billing system — the capacity that they require in order to compete with the BOCs' bundled offerings — will be disbanded and dismembered, reducing the number of active market participants and facilitating the BOCs' ability to increase prices following the departure of one or more stand-alone rivals. The BOCs have both the means and the incentive to engage in predation, and will have the ability to raise prices once their rivals are forced out of the market. Moreover, as I have discussed previously and notwithstanding the existence of price cap regulation, the BOCs are able to engage in predatory conduct via cross-subsidization of their below-cost long distance prices from high-margin local services. Even if their predatory conduct is ultimately unsuccessful, they incur no losses from having pursued a price squeeze strategy. And if successful, that strategy will support higher prices and higher profits in the future.

Price cap regulation is not by itself sufficient as a means for identifying or for preventing a BOC from using excess profits generated from monopoly local services to cross-subsidize competitive long distance services.

97. BOCs have frequently sought to dismiss claims that they are engaging in predatory pricing when offering retail long distance services at prices below their own wholesale access charge levels by professing an inability to engage in cross-subsidization when operating under "pure" price cap regulation. In its 1997 *LEC Classifications Order*, the Commission similarly concluded that under price cap regulation the BOCs would have neither the ability nor the incentive to engage in cross-subsidization of competitive services by raising the prices of monopoly services.[117] Under this theory, "pure" price cap regulation supposedly limits the BOCs' ability to increase prices for monopoly services, thus removing the "engine" that would be needed in order to engage in a cross-subsidization strategy.

98. *Price caps remove regulatory oversight and therefore facilitate cost shifting through methods such as improper affiliate transactions.* A recent regulatory audit of SBC-Pacific Bell undertaken by the California Public Utilities Commission[118] provides further demonstration of the utter ineffectiveness of price cap regulation — which has been in effect for Pacific Bell in California since January 1, 1990 — in preventing the transfer of monopoly revenues out of the operating company for the benefit of its nonregulated affiliates, *despite the nominal "de-linking"*

117. *LEC Classification Order*, at paras. 126-128. 12 FCC Rcd 15756, 15829 (1997).

118. California PUC, *Regulatory Audit of Pacific Bell For The Years 1997, 1998, and 1999*, Overland Consulting, issued Feb. 21, 2002 and supplemented May 8, 2002 and June 20, 2002.

of revenues and costs. The Audit Report found, among other things, that SBC-Pacific Bell and its affiliates had engaged in improper cross-subsidization, allowing SBC-Pacific Bell to substantially understate its operating income by, for example, transferring SBC-Pacific Bell CPNI for use by affiliates without reimbursement to SBC-Pacific Bell, and by paying the parent company SBC $400-million annually for SBC-Pacific Bell's use of the SBC brand name in California despite the transactions providing no apparent benefits to SBC-Pacific Bell. The California *New Regulatory Frameworks* ("NRF") price cap plan is subject to periodic (typically triennial) reviews by the California PUC. Hence, the creation of such bogus "costs" and uncompensated transfers of value to an affiliate works to understate both realized productivity *and* realized earnings. These (apparent) outcomes can then be advanced by SBC to support sought-after modification to the price adjustment mechanism, such as reduction or elimination of the productivity target (X-factor), elimination of any earnings sharing requirement, or other changes beneficial to SBC. If successful, SBC will have been able to shift costs attributable to its competitive long distance business over to its monopoly local exchange service customers. Thus, while there may be many desirable features of price cap regulation relative to traditional rate of return regulation, the foreclosing of cross-subsidization of competitive services is certainly not one of them. Indeed, the experience in California and elsewhere suggests that, to the extent that cost and earnings reporting may be reduced as part of the shift to incentive-based regulation, the net effect of price cap regulation may well be actually to *facilitate* cross-subsidization of the BOC's (and its affiliates') competitive services by making such tactics far more difficult to detect.

99. *Price cap plans often allow upward price movements on individual services, either as a result of reclassification or "baskets" of services.* The BOCs' creation of local/long distance service bundles easily overcomes any price cap limitation, if indeed it is actually present at all. Under price caps, only the overall *rate level* is capped; ILECs are afforded considerable flexibility with respect to the pricing of *individual* services within so-called "service baskets." Many state price cap plans permit the ILEC to "reclassify" services as "competitive" upon a demonstration of the presence of some limited number of alternative providers. In seeking such reclassifications, the BOCs are generally not required to affirmatively demonstrate that the level of competition that they claim to exist is sufficient to limit their ability to increase prices, i.e., to constrain their exercise of market power. Indeed, upon such reclassifications of putatively "competitive" services, BOCs are afforded pricing flexibility in both the *upward* as well as in the downward direction, and have indeed taken advantage of that *upward* pricing flexibility to increase rates on services reclassified as "competitive" in some cases almost immediately after the reclassification has been granted.[119]

119. Telecommunications Division, Illinois Commerce Commission, *Staff Report on Competitive Reclassification*, issued November 25, 1998. The ICC Staff found (at 5) that "[b]etween March of 1997 and November of 1998, Ameritech Illinois filed twelve tariff filings in which it reclassified several of its business and residential services as competitive." These were all in the form of tariff filings made on one day''s notice, and were permitted to go into effect. As the Staff Report notes (at 10), "[a]fter declaring some of the services listed above as competitive, Ameritech increased the retail and wholesale rates for those services." In some cases, *the prices of services that were already set well in excess of cost*, such as local usage, were increased.

100. Such practices are not confined to the state jurisdictions. BOCs have increased rates for *interstate* special access services in markets for which they have qualified for pricing flexibility, to the point where special access rates applicable in so-called "competitive" MSAs are in many instances *higher* than the corresponding rates in noncompetitive MSAs where the special access rates remain subject to price caps.[120] The "baskets" of services method of price cap regulation allows the BOC to use the excess profits from special access services to subsidize truly competitive services in the same basket.

101. Because BOCs often retain considerable market power with respect to "reclassified" services, they can increase rates for those services price caps notwithstanding, and use the excess profits derived therefrom to cross-subsidize services for which effective competition is actually present. The local/long distance "bundles" are undoubtedly quite profitable as a whole, even though the incremental price for the long distance calling feature is less than the applicable access charges. This is the case because the various vertical service features that are included in the bundle (call waiting, three-way calling, call block, caller ID) are so enormously profitable that their inclusion in the "bundle" is more than sufficient to offset the loss arising from the below-cost pricing of long distance. And, because these services are inextricably linked to the local exchange service platform, they cannot be offered by an IXC that does not also provide local dial tone to its long distance customer. Such stand-alone IXCs — and services offered by

120. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, RM No. 10593, Declaration of Joseph M. Stith on Behalf of AT&T, October 15, 2002.

IXCs that are not bundled with the subscriber's dial tone line — are thus vulnerable to the precise type of cross-subsidization that is inherent in the BOCs' local/long distance bundles.

102. These limitations of price cap regulation go directly to the core of the issue being addressed in this FNPRM. As *non-dominant* carriers, BOC long distance affiliates are not required to provide any cost support for their tariffs or (non-tariffed) prices. Although the BOC Section 272 affiliates (and the BOCs themselves following "sunset" of the separate affiliate requirement) are supposedly subject to the Section 272(e)(3) access charge imputation requirement, without any obligation to provide cost support for their prices there is no formal mechanism by which the Commission can assess whether or not the BOC is in compliance with Section 272(e)(3). Counsel advises me that, as non-dominant carriers, BOCs and their Section 272 affiliates are not required to *prove* that their prices comply with the statutory prohibitions against cross-subsidization and that they satisfy the statutory imputation requirements; the burden of proof that they do not is borne by an aggrieved party, whose sole recourse is to initiate a formal Complaint with the Commission. If history is any indication, it could take anywhere between 12 and 24 months for such a Complaint to be litigated and resolved, and even if the BOC's practices and prices are ultimately found to be unlawful, the BOC will have enjoyed the benefits of those unlawful prices for as long as the Complaint remains unresolved. Inasmuch as BOCs have been successful in adding 20 to 30 percentage points to their long distance market shares in states in which they offer in-region interLATA services during comparable 12-24 month periods, the potential losses to competitors would be irreparable.

103. Indeed, this may well provide a convenient basis upon which to evaluate the efficacy of treating the BOCs as dominant long distance carriers. Truly *non-dominant* long distance carriers have neither the economic wherewithall to engage in protracted below-cost pricing, nor the market power to materially impact competitors even if they did. BOCs, in contrast, possess both of these attributes. Absent the kind of *affirmative* regulatory oversight that is only possible where the BOCs are treated as dominant carriers, they will be able to crush their non-integrated rivals and ultimately remonopolize the national long distance market.

The Commission must adopt strong performance measures, enforced through an audit procedure, to ensure nondiscriminatory provisioning of special access services and facilities.

104. In addition to stringent imputation safeguards, the Commission must adopt strong performance measures and standards, supported by meaningful sanctions for discriminatory performance, to address the deficiencies in the BOCs' provisioning and support of special access services, such as those identified in both the New York and the Texas Audits.[121] The Commission should adopt the Joint Competitive Industry Group ("JCIG") Proposal under consideration in the *Performance Measurements and Standards for Interstate Special Access Services* proceeding, as well as implement a separate audit procedure for performance reports, to replace the Section 272 Audit review of these results.[122]

121. See para. 61-70, *supra*.

122. *Performance Measurements and Standards for Interstate Special Access Services*, CC Docket No. 01-321, Comments of AT&T Corp., filed Jan. 22, 2002, at 23-29.

PREREQUISITES FOR BOC NON-DOMINANT CLASSIFICATION

Any public policy rationale for above-cost pricing of switched access services that may have been valid in the past no longer exists and cannot be squared with the goals of assuring and maintaining a competitive long distance market.

105. The policy of above-cost pricing of switched access service was driven by public policy considerations following the break-up of the former Bell System in 1984 as a means for maintaining the pre-divestiture practice of using toll revenues to subsidize basic residential service. Previously, long distance toll rates were set well in excess of cost, with the bulk of total long distance revenues flowing to the local Bell companies via the intracompany "Division of Revenues Process" ("DRP") and to other ILECs via the settlements process. These arrangements were replaced by explicit, tariffed access charges in both the state and interstate jurisdictions. IXCs would pay access charges to the BOCs and other ILECs, and would recover these access charge payments in their retail long distance rates. As the long distance market became increasingly competitive following the break-up of the former Bell System, operating margins (between the retail price and the access charge payments) were commensurately narrowed, to the point where the principal cost component of retail long distance prices today is the above-cost access charge payments that the IXCs are forced to make to the BOCs and other local exchange carriers.

106. At the time access charges first went into effect in 1984, the BOCs were precluded from competing with the IXCs in the interLATA market and, in most instances, the IXCs were

not permitted to compete with the BOCs for intraLATA traffic. BOCs and many other ILECs were excluded from the interLATA long distance market either by the MFJ[123] or by the GTE/ Sprint Consent Decree.[124] IXCs initially did not even compete with BOCs in the *intraLATA* toll market. In fact, AT&T and the other IXCs did not even receive authority to offer intraLATA services in many states until the mid-1990s.[125]

107. As such, the policy of setting access charges well in excess of cost did not provide the BOCs with a competitive advantage vis-a-vis IXCs nor competitively disadvantage IXCs vis-a-vis BOCs. However, access charges did operate to generally suppress demand for long distance services by forcing IXCs to set higher long distance prices than would have occurred had access charges been set at cost, thereby depressing IXC revenues and profits and denying consumers the benefits of lower long distance rates.

108. At the interstate level, switched access charges have been reduced by more than 90% since they were first introduced in 1984.[126] This was accomplished, in part, by shifting the

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123. *U.S. v. American Tel. And Tel. Co.*, 552 F. Supp. 131 (D. D.C., 1982), *aff'd sub nom. Maryland vs. U.S.*, 460 U.S. 1007 (1983); and *Modification of Final Judgment*, sec. VIII.B.

124. United States v. GTE Corporation, 603 F.Supp. 730 (D.C. Cir. 1984).

125. AT&T was authorized to provide intraLATA services in Virginia in 1995. *Investigation of Competition for intraLATA, interexchange telephone service,* Virginia State Corporation Commission, Case No. PUC850035, *Opinion*, July 24, 1995.

126. FCC *Trends in Telephone Service, 2002.* FCC IATD, released May 22, 2002, Table 1.2.

recovery of non-traffic-sensitive ("NTS") costs (principally costs of the subscriber loop) from usage-based per-minute access charges (the so-called "Carrier Common Line Charge" ("CCLC")) to fixed monthly end-user "Subscriber Line Charges" ("SLCs"). While various consumer advocacy groups vociferously resisted the imposition of and subsequent periodic increases in the SLC, consumers responded by sharply increasing their volume of long distance calling, a trend that continued until wireless carriers began offering even better deals — and not only has there been no drop-off in demand for basic local residential exchange service, penetration rates have actually risen, from 91.4% in 1983 to 95.1% today.[127]

109. A BOC's ability to capitalize on its avoided access charges is only relevant while access charges remain in excess of cost. When access charges are set equal to the economic cost of terminating traffic, the access costs confronted by the BOC when providing long distance service become much closer to those confronted by competing IXCs, and the importance of the fact that the BOC does not actually make cash payments to itself diminishes. Whether paid for in cash by a nonaffiliated IXC or furnished by the BOC to itself, when access charges are set at TELRIC (or other valid incremental cost standard) the costs that the BOC incurs in producing the service and the costs that the IXC pays in acquiring the service should be quite close.

110. A BOC's *separate* Section 272 affiliate, in its capacity as an interexchange carrier, has exactly the same ability to provide both intraLATA and interLATA services to its customers as

127. *Id.*, at Table 17.2.

any non-BOC IXC, such as AT&T or WorldCom. If in the course of doing so the 272 affiliate is required to obtain intraLATA facilities from the BOC's local service entity (e.g., "one intraLATA arrangement from Dallas to the 272 affiliate's point of presence (POP) [and another] ... intraLATA serving arrangement from the 272 affiliate's POP to the Houston location"), *that is no different from what any nonaffiliated IXC would also need to do in order to provide an end-to-end service to a retail customer*. Just as AT&T (as an IXC) can offer its customers end-to-end services by combining access services purchased from BOCs with interexchange network facilities owned by AT&T, so too can the SBC or Verizon 272 affiliate (as an IXC) offer its customers end-to-end services *on an entirely equivalent basis*. Moreover, just as a non-affiliated IXC is *allowed* to own the facilities interconnecting its customers' premises with its POPs, in which event the IXC can perform full end-to-end testing and provide "seamless" end-to-end services *with respect to those specific circuits*, the BOC 272 affiliate is also "allowed" to own "last mile" facilities, just like any other IXC. The fact set under which the BOCs would face a competitive disadvantage *vis a vis* their IXC competitors is one in which non-BOC carriers owned *extensive*, near-ubiquitous collections of "last mile" assets. Under any other set of market conditions — and it is that "other" set of conditions that actually prevails here — integrated operation of the local and long distance functions of the BOC would afford the BOCs a level of competitive advantage as formidable and pervasive as that which led to the break-up of the former Bell System.

111. Upon sunset of the Section 272 requirements, the BOC IXC business unit, which could then be integrated into the BOC, is in a position to — and undoubtedly will — obtain superior

access to the intraLATA segments relative to what would be available to nonaffiliated IXCs. This is essentially the same situation as has arisen in the case of intraLATA services, where BOCs do not make use of the same "access services and facilities" that are provided to IXCs, thus making the imputation "safeguard" simply not sufficient to protect the IXC from highly discriminatory BOC conduct.

112. From many years' experience in dealing with BOC provision of *intraLATA* services in competition with IXCs, we now know that in providing such competitive services (and they have been deemed "competitive" and have been detariffed in a number of states), the BOCs do not themselves utilize the same type of "access services" that are provided to competing (nonaffiliated) IXCs. For example, a number of BOC intraLATA toll calls are completed over direct end office-to-end office trunks or through a single tandem; in some cases where multiple exchanges have been consolidated into a single central office switching entity, toll calls among such exchanges will actually be completed on an entirely *intraswitch* basis. When an intra-LATA toll call is routed via an IXC, two separate access tandem connections are almost always required, typically involving additional switching and transport *for which the IXC pays*. BOCs have regularly argued in state PUC imputation proceedings that they should be permitted to impute the cost of the facilities they actually use, and not the price that they charge IXCs for the facilities that IXCs use.

CONCLUSION

113. The survival of competition in the long distance market requires that the BOCs' ability to leverage their entrenched local service monopoly into the adjacent — and presently competitive — long distance be constrained. Classification of the BOCs as dominant long distance carriers provides the regulatory mechanism that is needed to implement and to enforce this policy. As dominant carriers, BOCs will be compelled to set their prices in compliance with the statutory imputation and nondiscrimination requirements and with the Commission's cost allocation rules, and to justify those rate filings with full documentation and cost support. The extraordinary and unprecedented rate at which BOCs, following their receipt of Section 271 in-region long distance authority, have succeeded in acquiring retail customers — leading to SBC's projection of a 60% end-state market share — raise serious concerns as to the potential for BOC remonopolization of the long distance market. Moreover, it is inconceivable, in light of the BOCs' extraordinary success in ramping up their long distance operations, that the BOCs can legitimately claim that dominant carrier treatment would place them at a competitive disadvantage relative to their non-dominant rivals. Accordingly, and as long as the BOCs remain fully compliant with the 1996 *Act* and with applicable FCC imputation, tariff filing, and cost allocation rules, the classification of BOCs as dominant long distance carriers will serve only to assure that competition in this sector can be sustained, while imposing no consequential costs or regulatory burdens upon the BOCs.

The foregoing statements are true and correct to the best of my knowledge, information and belief.

Lee L. Selwyn